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TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 1323

together with

SUPPLEMENTAL AND ADDITIONAL VIEWS

DECEMBER 17 (legislative day, DECEMBER 15), 1987.—Ordered to be printed

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CONTENTS

	Page
Introduction	1
Purpose of the legislation	1
Summary of major provisions	3
Vote to report the bill	6
History of the legislation	6
The need for securities law reform	8
Trends in merger activity	9
Manipulation in the tender offer process	10
Corporate debt attributable to takeovers	12
Takeover impacts on employment and communities	14
Economic arguments	15
1. Impact on investors	15
Bondholders	15
Target and bidder shareholders	16
2. Corporate efficiency	17
Catalog of reforms	18
I. Disclosure of stock purchases	18
A. Closing the 10-day window period	18
B. Time for filing amendments	20
C. Insider reports	20
D. Disclosure of control intent	20
E. Tighter regulation of group activity and fuller disclosure of communications during 30 days before acquisition	22
F. Financing disclosure	25
G. Fee disclosure	25
H. Civil liability for violation of disclosure requirements	26
II. Tender offer procedures	27
A. Tender offer period	27
B. Tender period for firms with employee ownership	29
C. Tender offer threshold	30
III. Greenmail	32
IV. Standards for operation of pension funds	34
A. Long term perspective	35
B. Excess pension plan assets	35
V. Proxy disclosure	37
VI. Studies	37
A. To analyze potential abuses of leverage buyouts, the SEC shall study such transactions	37
B. The SEC shall study the proxy process	38
VII. Increased insider trading penalties, Chinese wall procedures, registration and regulation of arbitrageurs	39
A. Increased insider penalties	39
B. Chinese wall procedures	40
C. Registration and regulation of arbitrageurs	42
VIII. The respective State and Federal roles in regulating tender offers	44
A. The traditional role of the States	44
Corporate governance	44
Regulation of securities	46
B. Federal regulation of tender offers (The Williams Act)	47
C. The Constitutional relationship of State and Federal laws affecting control contests	48
Edgar v. *Mite*	49
CTS Corp. v. *Dynamics Corp*	50

Catalog of reforms—Continued Page
VIII. The respective State and Federal roles in regulating tender offers—Continued
D. Committee rejection of proposals that might affect the CTS decision 51
"One share/one vote proposals" 53
Defensive tactics 54
E. Conclusion 55
Table 1—Second generation State takeover laws 56
Control share acquisition statutes 56
Fair price statutes 56
Cash-out statutes 56
Business combination statutes 56
Section-by-section discussion of the bill 56
Section 1. Short title 56
Section 2. Findings and purpose 56
Section 3. 10-day window; contents of report 57
Section 4. Time for filing amendments 59
Section 5. Group activity, enforcement measures, and content of public announcement 59
Section 6. Civil liability 60
Section 7. Tender offers 61
Section 8. Greenmail 62
Section 9. Registration and regulation of arbitrageurs 63
Section 10. ERISA amendments 63
Section 11. Increase access to proxy statements for shareholders 64
Section 12. Chinese wall procedures 64
Section 13. Insider reports 65
Section 14. Increased penalties for insider trading, perjury, and obstruction of justice 65
Section 15. Role of State law 65
Section 16. Commission studies 66
Section 17. Study of one share/one vote 66
Regulatory impact statement 66
Changes in existing law 67
Cost of legislation 67
Additional views of Senator Proxmire 69
Additional views of Senators Sasser, Sanford, and Chafee 70
I. Introduction 70
II. The economic evidence: Hostile takeovers do not guarantee greater efficiency 70
A. Target corporations are generally wellrun 70
B. Hostile takeovers do not create more efficient companies 71
1. Other cures of inefficient management are effective 72
2. Other productive economies do not permit hostile takeovers 73
C. The impact of hostile takeovers 73
1. The negative short- and long-term effects of increased corporate debt 73
2. Loss of jobs 75
3. Detrimental effect on the community 77
4. Reduction of expenditures for research and development 77
5. Adding to the volatility and overvaluation in the stock market. 78
6. A resulting short-term focus 79
III. The State role in regulating corporate governance and contests for control should be reaffirmed 80
A. The traditional role of the States on matters of internal corporate governance and the *CTS* decision 80
1. State regulation affords greater flexibility to foster and adapt to change 82
2. State regulation is not biased in favor of management 82
3. State regulation should not cause "Balkanization" or interfere with the National securities market 83
4. State regulation does not preclude takeovers 83
5. State regulation does not deny voting rights 84
6. State regulation should not cause corporations to race to find the most protective State statutes 84
7. Federal preemption of State laws would create protracted litigation 84
8. State regulation will not "Tip the Balance" against the bidder. 84

Page

Additional views of Senators Sasser, Sanford, and Chafee—Continued
III. The State role in regulating corporate governance and contests for control should be reaffirmed—Continued
B. The four model approaches adopted by the States and other State law provisions 85
1. Control share acquisition laws 85
2. Fair price laws 85
3. Five-year freeze-out laws 85
4. Control share cash-out laws 86
5. Other types of State laws relating to contests for control 86
C. Back-door preemption: One share/one vote 86
IV. Conclusion 89
Additional views of Senators Dodd, Cranston, Wirth, Bond, and Karnes 90
State law 92
Management defensive tactics 92
One-share/one vote 93
Supplemental and additional views of Senator Shelby 95
Additional views of Senator Garn 97
Additional views of Senator D'Amato 99
Part I 100
A. Introduction 100
B. S. 1323 contravenes the original intent of the Williams Act 101
C. The proponents of anti-takeover legislation 103
D. The economic evidence: Myth v. Reality 110
E. Hostile takeovers and insider trading 120
Part II 122
A. Introduction 122
B. One share/one vote 123
C. Confidential proxy voting 125
D. Shareholder rights 127
1. Application of amendment to control share acquisition statutes 128
2. Application of amendments to the 5 year freeze out statutes 128
3. The limited scope of the amendment 129
4. The implications of the CTS decision for the current debate on corporate takeovers 129
E. The role of State and Federal regulation in governing takeover activity: A rebuttal of the report's analysis of the *CTS* decision 135
"Role of State law" 136
F. Greenmail, golden parachutes and poison pills 144
Part III 146
A. Introduction 146
B. Section 3 146
1. Section 3(b) 146
2. Sections 3(c) and 3(e) 147
3. Section 3(d) 148
C. Section 5—Change of intent; 60 day freeze 149
D. Section 6—Civil liability 152
E. Section 7—Minimum offering period 154
F. Section 8—Greenmail 155
G. Section 9—Registration of arbitrageurs 156
H. Section 12—Chinese walls 157
I. Section 14—Criminal penalties for insider trading 158
Conclusion 159

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TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987

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Mr. PROXMIRE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

SUPPLEMENTAL AND ADDITIONAL VIEWS

[To accompany S. 1323]

INTRODUCTION

On September 30, 1987, the Senate Committee on Banking, Housing, and Urban Affairs (the "Committee") marked up and ordered to be reported a bill, the Tender Offer Disclosure and Fairness Act of 1987 (the "bill"). The bill expands existing requirements for disclosure of major stock acquisitions and strengthens the ability of the Securities and Exchange Commission (the "Commission") to deter tender offer abuses and insider trading. Many of the changes are intended to "provide shareholders more effective and fuller disclosure and greater fairness with respect to accumulations of stock, the conduct of tender offers, and other changes of corporate control."

The Committee vote was 14 ayes and 6 nays to adopt the bill and report it to the Senate for consideration.

PURPOSE OF THE LEGISLATION

Since the enactment of the Williams Act 20 years ago in 1968, vast changes have occurred in the motives underlying, and the manner in which, contests for control by tender offer are conducted.

The Williams Act was intended to close loopholes in the Federal securities laws by requiring full disclosure and the equal treatment

of all investors in connection with tender offers. Today, however, powerful new market forces and an array of newly developed takeover techniques have undermined the protections afforded investors by the Williams Act.

Legislation is now needed to close gaps in the Williams Act that have permitted this situation to arise.

Traditionally, takeover activity was motivated by the notion that companies could achieve long-term growth by diversifying and expanding through corporate acquisitions. Today, however, many takeovers are based solely on a desire for immediate, short-term returns with no thought to actually managing the target company. Bidders put a company "into play" by acquiring large blocks of a target company's stock with virtually no risk and with an almost certain guarantee of substantial profits through greenmail, bust-up liquidation of the target or a white knight rescue.

The phenomenon of the threatened takeover places well run corporations on the auction block or forces them to restructure financially. These takeovers have significant implications for the national economy, international competitiveness of American firms, corporate debt, community stability, unemployment and investor protection.

Although target company shareholders may benefit from a temporary run-up in the price of the target's stock, concerns over the fairness and integrity of the overall process persist.

Notwithstanding gains realized by some target shareholders, others have been deprived of information necessary to make an informed investment decision and have been denied a fair share of the control premium paid to acquire the company. Also, other parties to the transaction such as bidding company shareholders and target company bondholders have suffered economic loss and have not received adequate consideration in the tender offer process.

No one denies that mergers and acquisitions may produce social benefits through better managed companies and opportunities for growth. However, the proliferation of abusive takeover techniques, which have as the primary goal the precipitation of excessive speculation in the securities of the target company, has forced corporate managers to focus their energies on short-term performance. This has major implications for research and development as well as for long-term growth and competitiveness at home and abroad.

All of this is well summarized by Akio Morita, Chairman of Sony Corporation, who recently wrote: "Unfortunately, American industry is now being distracted by a game called mergers and acquisitions. America's brighest managerial talent is engaged in takeover moves and empire building. The best students do not study engineering but become MBA's or lawyers and, eventually, professional moneymakers. This is not a productive enterprise."

In addition, an enormous amount of debt is being incurred in connection with takeovers. In part, this is because of the use of junk bonds to finance hostile tender offers or defensive leverage buy-outs. This has contributed to a sharp increase in debt-to-equity ratios and a concomitant decline in the credit rating of many companies. It is now widely recognized that many former takeover targets and junk bond investors, particularly financial institutions,

will be vulnerable to defaults in the event of adverse economic or financial developments.

Based on the hearing record, the Committee agreed to amend the Williams Act. Many of the changes made are designed to improve the disclosure available so as to make the tender offer process fair for all investors. The bill states as its purposes: "(1) to reduce the opportunities for abuse under the Federal Securities laws as currently in effect, and (2) to expand the protective mechanisms of such laws". Other changes are designed to improve the integrity of the tender offer process and the capital markets by addressing abuses in the current system.

As John J. Phelan, Jr., Chairman and Chief Executive Officer of the New York Stock Exchange has put it: "[W]e need to ensure that when takeover attempts occur, they do so in an environment that minimizes the potential for abuse. That means getting more sunlight into the arena faster. And letting as many people as possible know at the same time what's happening in the marketplace."

Summary of Major Provisions

To accomplish these purposes, the Committee agreed to a number of specific changes to the Williams Act which may be generally summarized under the following categories:

1. *Purchase disclosure schedule.*—Under current law, any person who acquires more than 5 percent of a company's stock need not file a disclosure statement until 10 days after the acquisition that exceeds the 5 percent threshold. This has permitted stock acquisitions much greater than 5 percent during the 10 day window period before any disclosure is required. As a result, by the time the first disclosure is made a person may have secretly accumulated a control interest in the company. The bill does not disturb the existing 5 percent threshold requirement. However, to alert shareholders to important purchases of the company stock on a more timely basis, buyers are required by the bill to disclose the acquisition of a greater than 5 percent stake in a company within five days rather than the current 10 days of reaching this level of ownership. Most importantly, until the disclosure is filed, further purchases beyond 5 percent are prohibited.

In addition, the standards under current law as to when an acquiror must file amendments to the original disclosure after there has been a material change in his holdings or situation are insufficiently rigorous. Under the bill, additional material stock purchases by these buyers beyond the original 5 percent level must be disclosed within 1 day of each purchase.

The bill also makes explicit that disclosure of coordinated buying programs involving separate acquirors is required even in the absence of an agreement to act together between the individual participants. To ensure that the members of informal groups, who operate by means of a wink and a nod, do not individually acquire stock in a common effort in order to evade these disclosure requirements, this legislation will emphasize that buyers who act together in purchasing a cumulative stake greater than 5 percent must disclose the acquisition, whenever they act together pursuant to an express or implied agreement or understanding.

Finally the bill requires that company officials and other insiders report any change in their ownership of stock in their company within 5 days of each transaction, rather than within 10 days of month-end as required under current law.

2. *Disclosure details and enforcement mechanisms.*—The bill clarifies existing disclosure requirements and, in some carefully drawn aspects, broadens the current law's disclosure scope. For example, under current law pre-filing communications regarding an acquisition need not be disclosed nor is important information on the buyer's financing, fees, and repayment plans required. Under the bill, the disclosure required with respect to acquisitions must include the identity of other large shareholders with whom the acquisition was discussed during the 30 days preceding the disclosure, along with information on the buyer's financing and fees.

An additional clarification to existing disclosure requirements is a provision in the bill that eliminates the current ambiguity permitted in disclosing investment intent. Buyers will be required to disclose clearly whether their acquisition is either (1) for passive investment purposes; or (2) for control of the company.

The bill remedies a shortfall in the current law by adding a prophylactic provision designed to ensure accurate disclosure of investment intent at the outset: Buyers who claim that the purpose of their purchase is to make a passive investment may not change that intent and make a tender offer unless the buyer notifies the SEC of this new intent and then waits for a period of 60 days.

Finally, the bill provides for an effective deterrent to violations of the disclosure requirements. The principal remedies for violations of disclosure requirements relied on by the courts to date have been orders against continuing violations or orders requiring that the original false disclosure be corrected. The bill raises the penalties for false disclosure in order to make them more commensurate with the high rewards involved in modern takeover attempts. The Securities and Exchange Commisson is empowered to sue for tender offer disclusire violations and to seek penalties of up to 50 percent of the value of securities in question. The bill also recognizes the courts' authority to impose, and specifically endorses the broader use of, equitable remedies such as divestiture or sterilization of voting rights as a necessary component of effective deterrence of tender offer disclosure violations.

3. *Tender offers.*—In order to help shareholders better assess a bid, the tender offer period is lengthened from the current required minimum of 20 business days to 35 business days. In addition, the bill adds a new requirement that where an Employee Stock Ownership Plan controls more than 10 percent of a firm that is the object of a tender, and these employees formally notify the issuer and bidder of their intent to make a competing offer on terms substantially equivalent to the existing offer, the tender period is lengthened by 60 additional business days.

The bill also extends the shareholder protections of the existing tender offer process to eliminate techniques sometimes used to acquire control of a company outside of the tender offer framework. To assure all shareholders a fair opportunity to participate in the offer and to avoid circumvention of the protections of the Williams

Act, any purchase above 25 percent of a company must be made through a tender offer, subject to a number of exceptions.

The legislation also clarifies the duty of a trustee, such as a pension plan manager, in reacting to a tender offer for shares under his control. Under current law, trustees have been concerned that they may incur liability to the plan beneficiaries in any case where he or she refuses to tender at a premium above current market value. The bill includes a provision that specifically allows a trustee to consider long-term investment prospects in determining whether to tender shares in response to an offer—without fear of automatically violating the duty owed to beneficiaries.

4. *Proxy solicitation.*—The bill improves existing shareholder rights under SEC rules by adding a new requirement that owners of more than 10 percent of a company may, at the company's expense, include their own proxy materials and board candidates in the proxy materials and board candidates in the proxy statement distributed by the firm. Also, the SEC is directed to study the proxy solicitation process.

5. *Greenmail.*—The bill includes a provision designed to limit the practice known as "greenmail." The bill gives a corporation the right to recover any profit made by a person who sells the corporation its own stock, if that person holds more than 3 percent of the stock and has held it for less than 1 year. If the corporation does not act to recover the profit, a shareholder may do so on behalf of the corporation. This section does not apply if the stock purchase was approved by the majority of shareholders or was made pursuant to an offer available to all shareholders. In addition, the SEC is given rulemaking authority to establish exemptions from this provision.

6. *Pension plan protection.*—Current law does not protect excess pension fund assets from use in takeovers by either the bidder or management. In order to preserve excess funding as a cushion for employee benefits, the bill prohibits bidder and target companies from tapping the surplus in pension funds to finance takeover attempts. However, the bill does permit pension surpluses to be transferred to an Employee Stock Ownership Plan (if a majority of all pension plan participants agree to do so by vote) which, in turn, can be used by employee stockholders to mount a bid.

7. *Arbitrage.*—Under present law, many firms that regularly trade or arbitrage stocks that are the object of takeovers must register with the SEC as broker-dealers. However, a number of arbitrageurs, who are a major force in takeover contests, remain unregistered and unregulated. The bill requires arbitrageurs who are not already registered with the Commission do so so. In addition, the legislation expressly affirms the SEC's authority to require multiservice financial firms to establish appropriate restrictions on the internal flow of information, or "Chinese Walls," between the firm's various departments, such as the tender offer arbitrage department and merger and acquisition department.

8. *Insider trading penalties.*—The bill raises the criminal penalties for insider trading from $100,000 and/or 5 years in jail to $1 million and/or 10 years in jail. A new requirement also provides that perjury or obstruction of justice in the course of an insider

trading violation investigation carries a mandatory 1-year sentence in addition to any other applicable penalty.

9. *The Role of States.*—The bill is intended to have no effect on the role of States in governing the internal affairs of corporations. A study of the role of the States is required as is a study on the subject of shareholder rights. Studies are also authorized on leveraged buyouts and the proxy solicitation process.

VOTE TO REPORT THE BILL

14 yeas: Proxmire, Cranston, Riegle, Sarbanes, Dodd, Dixon, Sasser, Sanford, Graham, Wirth, Heinz, Bond, Chafee, Karnes.

6 nays: Shelby, Garn, Armstrong, D'Amato, Hecht, Gramm.

HISTORY OF THE LEGISLATION

The Senate Committee on Banking, Housing, and Urban Affairs held hearings on corporate takeovers on January 28, March 4, April 8, April 22, June 23, June 24, June 25, and June 26, 1987. Witnesses at these hearings included, among others, representatives from the investment banking community, corporate America, labor, law enforcement officials, the Securities and Exchange Commission, the Administration, institutional investors and the States.

On January 28, 1987, the Committee heard from leaders of the financial and legal community as well as former commissioners who served on the Securities and Exchange Commission. Witnesses included Alan Greenspan, at the time Chairman of Townsend-Greenspan, and now Chairman of the Board of Governors of the Federal Reserve System; Nicholas F. Brady, Chairman, Dillon, Read & Co.; Felix G. Rohatyn, Senior Partner, Lazard Freres & Co.; Lloyd N. Cutler, Partner, Wilmer, Cutler & Pickering; and former SEC Commissioners Roderick H. Hills, now Managing Director and Chairman, The Manchester Group, Ltd.; A.A. Sommer, Partner, Morgan Lewis & Bockius; and Francis M. Wheat, Partner, Gibson, Dunn & Crutcher.

Chairmen and Chief Executive Officers of some of America's best known corporations were invited to testify before the Committee on March 4, 1987. Witnesses at this hearing included: David M. Roderick, Chairman and Chief Executive Officer (CEO), USX Corporation; Raymond Plank, Chairman and CEO, Apache Corporation; John L. Murray, Chairman and CEO, Universal Food Corporation; George S. Slocum, President and CEO, Transco Energy Company; Andrew C. Sigler, Chairman and CEO, Champion International Corporation; James K. Baker, Chairman and CEO, Arvin Industries; Donald C. Clark, Chairman and CEO, Household International; Thomas F. Frist, Jr., Chairman of the Board, Hospital Corporation of America; William R. Howell, Chairman of the Board, J.C. Penney, Inc.; William McKinley, Chairman and CEO, Gerber Products; Robert P. Luciano, Chairman and CEO, Schering-Plough Corporation; Robert E. Mercer, Chairman and CEO, Goodyear Tire and Rubber Company; William D. Smithburg, Chairman and CEO, The Quaker Oats Company; Alvah H. Chapman, Jr., Chairman and CEO, Knight-Ridder, Inc.; William E. Wall, Chairman of the Board, The Kansas Power and Light Company; and Clarence E. Johnson, President and CEO, Borg-Warner Corporation.

The following labor representatives testified at the April 8, 1987, hearing: Thomas R. Donahue, Secretary-Treasurer, AFL-CIO; William H. Wynn, President, United Food and Commercial Workers International Union; James E. Hatfield, President, Glass, Pottery, Plastics and Allied Workers International Union; Jacob Sheinkman, Secretary-Treasurer, Amalgamated Clothing and Textile Union; Milan Stone, President, Rubber, Cork, Linoleum and Plastic Workers of America; Jack Bavis, President, Master Executive Council, Eastern Airlines; Charles Bryan, President, District Lodge 100, International Association of Machinists and Aerospace Workers; Mary Jane Barry, President, Local 553, Transport Workers Union; Delbert Walsh, President, Local 252, Glass, Pottery, Plastics and Allied Workers International Union; and Clayton C. Oster, President, Local 26, United Rubber, Cork, Linoleum and Plastics Workers of America.

On April 22, 1987, the Committee received an update of the law enforcement activities of the government with respect to improper activities in the securities industry from Rudolph Giuliani, U.S. District Attorney for the Southern District of New York; and Gary Lynch, Director of the Division of Enforcement, Securities and Exchange Commission. This update included government enforcement actions related to insider trading and corporate takeovers.

The "Tender Offer Disclosure and Fairness Act of 1987" was introduced by nine members of the Senate Banking Committee on June 4, 1987. Legislative hearings were subsequently held on June 23, 24, 25, and 26, 1987.

On June 23, representatives from the Administration and the Securities and Exchange Commission testified. Beryl Sprinkel, Chairman, Council of Economic Advisers, testified on behalf of the Administration and the Securities and Exchange Commission was represented by Commissioner Charles Cox. A second panel included witnesses representing various state associations including: Daniel Bell III, President, North American Securities Administrators' Association; Anthony J. Celebrezze, Jr., Attorney General of the State of Ohio; Jim Edgar, representing the National Association of Secretaries of State; and Richard B. Geltman, Staff Director, Committee on Economic Development and Technological Innovation, National Governors' Association.

Representatives from the securities industry and the investment banking community testified on S. 1323 on June 24, 1987, as did labor. Witnesses at this hearing included John W. Bachmann, Chairman, Securities Industry Association; and Robert F. Greenhill, Managing Director, Morgan Stanley & Co., Inc. (representing the Capital Markets Group: The First Boston Corporation, Goldman Sachs & Co., and Morgan Stanley & Co., Inc.); followed by Laurence Gold, General Counsel, AFL-CIO.

On June 25, 1987, the Committee heard from the business community, institutional investors and a shareholder group. On the first panel were: H. Brewster Atwater, Jr., representing The Business Roundtable; Alexander B. Trowbridge, President, National Association of Manufacturers; and Donald C. Clark, representing Stakeholders in America. The second panel included Raymond J. Sweeney, CoChairman, Council of Institutional Investors; James Martin, Executive Vice President and Chairman, CREF Finance

Committee, College Retirement Equities Fund; and Margaret Cox Sullivan, Stockholders of America, Inc.

To complete the hearing record, the Committee considered the relationship of employee ownership and corporate takeovers on June 26, 1987. Witnesses included: Former U.S. Senator Russell Long, Partner, Finley, Kumble, Wagner, Heine, Underberg, Manley & Casey; F. Lee Bailey, Lead Trial Counsel, Eastern Airlines Coalition; Robert Strickland, Chairman, Lowes, Inc.; Randy Barber, Director, Center for Economic Organizing; Capt. William H. Palmer, United Airlines, President, Coalition Acting for the Rights of Employees; and Jared Kaplan, Partner, Keck, Mahin & Cate.

The Need for Securities Law Reform

The Committee's hearings on the subject of tender offer and securities law reform were held against a backdrop of the most serious insider trading scandals the Securities and Exchange Commission has ever uncovered and ongoing allegations of collusion and conspiracy amongst corporate raiders, arbitrageurs, investment bankers and other participants in the corporate takeover "game."

At the Committee's first hearing in the 100th Congress on the subject of hostile takeovers, on January 28, 1987, Nicholas F. Brady, Chairman, Dillon, Read and Co., Inc. testified that takeovers have given rise to a number of troubling activities including "profits on the part of raiders, arbitrageurs, and bankers that appear to be out of proportion." He also expressed concern that "many have also sensed that there was something titled about a game in which the same group of raiders, arbitrageurs, and bankers attack one company after another, reaping profits without ever seeming to take risks or losses." He concluded: "Something was just not right."

At the same hearing Felix G. Rohatyn, senior partner, Lazard Freres and Co., explained, "the basic concept of our securities laws has been full disclosure, nonmanipulation, and equal treatment of all shareholders." He went on to point out that "current techniques and legal trends undercut these concepts."

Among other things, he expressed deep reservations regarding a number of aspects surrounding the guilty plea to securities fraud and insider trading made by former arbitrageur Ivan Boesky, as well as the feverish speculation that has been an integral part of the takeover process. Rohatyn also expressed the following concern about the financing of the takeover process:

> "Very large pools of money are managed by arbitrageurs looking for rapid returns; some of these pools are financed by junk bonds. Equally large pools are in the hands of raiders, similarly financed. This creates a potentially interlocking set of relationships which has as its basic purpose the destablization of a large corporation and its subsequent sale or breakup. It creates, at the very least, the appearance, if not the reality, of professional traders with inside information, in collaboration with raiders and junk bond buyers, deliberately driving companies to merge or liquidate."

Statements such as these, repeated throughout the hearings, helped convince the Committee that there was a significant need

for reform of the tender offer and securities laws and led to findings in S. 1323 that: "the integrity of the Nation's securities markets and the confidence of the public in them, which are essential to the economic welfare of the country, have been threatened by the conduct of parties in tender offers"; "certain individuals and entities have sought to precipitate, intensify, and prolong excessive speculation in connection with acquisitions or proposed acquisitions of issuers of securities to the detriment of such issuers, their shareholders, and the public"; and "the existing enforcement remedies have not been adequate to deter violations of the Federal laws requiring timely, full, and truthful disclosure of significant accumulations of securities and plans to acquire or seek control of publicly held corporations."

The Committee was particularly concerned about allegations of manipulation in the takeover process, but also considered in its deliberations on S. 1323 evidence relating to the impact of corporate takeovers on corporate debt, employment, communities, and shareholders other than short-term investors. The Committee also considered evidence of leaks of nonpublic information in the takeover process as well as recent trends in merger activity.

Trends in Merger Activity

The Committee heard considerable testimony regarding the trends in merger and acquisition activity. Significant increases in the numbers of transactions, the value of transactions and the average size of transactions were noted.

Between 1981 and 1986 the number of merger transactions nearly doubled from 2,326 to 4,084.

The reported value of transactions nearly tripled during the same period from $67.2 billion in 1981 to $192.9 billion in 1986.

The average transaction value, where transaction value was disclosed, almost doubled from 1981 to 1986. The average transaction value in 1981 was $55.5 million, whereas by 1986 it has increased to $104.4 million.

Transactions over $1 billion grew four times in number and three times in dollar value, capturing over 34 percent of total mergers and acquisitions value in 1986. There were 8 transactions over one billion dollars in 1981, whereas, by 1986 there were 29 in excess of one billion dollars.

While hostile or contested tender offeers represent a small fraction of all transactions, they represent a significantly larger part of the value of these transactions. According to a Congressional Research Service study requested by the Committee, contested tender offers represent only 2.8 percent of the number of transactions but 44.4 percent of the value of all mergers and acquisitions, for which hte value of transactions was reported.

These data confirm that merger activity has been taking place at an increased rate, affecting the very largest companies, thus expanding the area of concern regarding the implications for abuse.

Manipulation in the Tender Offer Process

A number of prominent witnesses expressed concern over manipulation in the takeover process.

In this regard, the following scenario has been described to the Committee:

> Bidders identify corporations whose stock trades at a price below the value of the company as appraised in terms of its underlying assets. Such a company is not uncommon. In 1986, the average company traded at approximately 75 percent of its replacement value. Replacement value is the cost of purchasing the firm's plant and equipment under prevailing market prices.
>
> An investor then could purchase a considerable amount of stock, often 15 or 20 percent without public disclosure. While current law requires public disclosure after acquiring 5 percent, this disclosure need not be made for 10 days and does not foreclose further purchases during the 10 day period. In the meantime, other investors, including arbitrageurs and securities firms may also take positions of less than 5 percent—and avoid disclosing this additional accumulation provided they do not enter into formal or tacit agreements to acquire the stock. The more stock held in large blocks by a few speculative investors, or even institutional investors, the more vulnerable a corporation becomes to takeover pressures.
>
> Rumors circulate that a company is in play. To give the rumors substance, the speculators holding the stock may trade it back and forth to create the impression of heavy activity. Stock analysts will be attracted to the activity and rumors and they may further spread reports of an imminent takeover. The target corporation is likely to signal to the market that it will resist a takeover. By this time, the market price of the stock will have risen sharply and the original speculators can sell at a profit in an active market or hold on until the bidder makes another move. If the bidder decides to proceed, he will announce his intention to purchase, along with a purchase price which will be higher than the current market price. Often, the market price continues to rise to a level somewhere near the purchase price offer.

Under this scenario, the other original investors stand to profit handsomely whether or not the bid is ultimately successful. The bidder can exercise one of four options: selling the shares into the market at a profit; accepting a premium from the target company in exchange for ending the bid (greenmail); selling the shares at a premium to another bidder; or completing the bid.

Under the first three options, the bidder gains enormous short term profits at the expense of the vast majority of other shareholders. It was further described to the Committee that even in those instances where a bid is completed, the result can be diseconomic. Bidders typically must borrow funds to purchase the stock to complete their bid for the company. In order to repay the debt, the bidder often must restructure the company, including selling productive components and closing facilities in order to maximize short-term cash flow to meet debt requirements. The break-up and

disruption of newly acquired corporations is geared solely to meeting short-term debt service demands with little concern for planning and implementing any long-range objectives. The disruption has impacts far beyond the shareholders. It affects communities, employees, and the entire economy.

Often, management, convinced that the acquisition of the company by the bidder will result in mindless dismantlement of the company to the detriment of the long-term interests of shareholders, employees, communities and others with stakes in the corporation, will be driven to costly restructing moves that entail incurring huge debt. While often a better outcome than being subjected to a takeover, the dangers flowing from excessive debt, curtailment of long-term strategies, and shrinking the company resemble those that follow from a takeover. Evidence relating to the dealings of a noted takeover practitioner confirms the Committee's information with regard to this scenario of manipulation. Carl Icahn authored the following memorandum to potential investors in a speculative takeover fund he was establishing in 1980:

> It is our opinion that the elements in today's economic environment have combined in a unique way to create large profit-making opportunities with relatively little risk . . .
>
> It is our contention that sizable profits can be earned by taking large positions in "under valued" stock and then attempting to control the destinies of the companies in question by:
>
> (a) trying to convince management to liquidate or sell the company to a "white knight";
> (b) waging a proxy contest, or;
> (c) making a tender offer, and/or;
> (d) selling back our position to the company.

Commenting in the aftermath of the Ivan Boesky revelations John J. Phelan, Jr., the Chairman of the New York Stock Exchange remarked:

> "What we see is a relatively new phenomenon in which investment bankers, institutions, arbitrageurs, accounting firms, public relations firms and law firms join together in takeover activities. And in which enormous sums of money are in the balance.
>
> "This certainly raises the issue of an increased risk not only of insider trading, but of manipulation. Or what might be called modern pool activities."

He continued:

> "Since takeovers have provided the major opportunity for insider trading to occur, that indicated to me that there's a structural problem in our system that needs to be addressed.
>
> "By structural problem I mean that a window of opportunity exists in takeover situation in which a select number of people know beforehand that a takeover attempt is about to occur. It's from that that the current abuses flow."

In addition to numerous allegations of abuses in the takeover process, the Committee also found that in today's markets tender offers can be accompanied by outright fraud. U.S. District Attorney Rudolph Giuliani, whose office has recently prosecuted many infamous securities trading cases, told the Committee that "there's no

doubt that there is a connection between the number of insider trading cases . . . and the substantial increase in the number of takeovers." In the last three years, the government has successfully prosecuted 50 cases in this area, five times the number from the previous 50 years.

In testimony before the Security Subcommittee on May 13, 1987, former SEC Chairman Shad expressed his concern about collusion:

> "I think these networks have been informal—in fact, most of them I don't think are really formalized. I don't believe it's organized criminal activity. These are highly sophisticated people. There are graduates of leading law and business schools involved. That's the shocking part of it. . . . Some of the recent cases clearly demonstrate the group activity. The economic incentives for that sort of activity are enormous. For example, we have seen Mr. Beosky with $50 million of illicit profits."

Finally, the pervasive scope of abuse now associated with corporate takeovers has been highlighted by someone particularly familiar with the details of the current major takeover related criminal cases and ongoing investigations. Assistant U.S. Attorney John Carroll, one of the prosecutors involved in the Boesky case, was recently quoted as warning that manipulative schemes associated with takeovers are "certainly widespread . . . serious, extensive, systematic . . . we are dealing with a systematic corruption that undermines the financial world."

In addition to allegations of collusion and manipulation in the current takeover process, there is mounting evidence that preannouncement information leaks on takeovers result in significant losses to most shareholders. For example, according to Mergers and Acquisitions, it is estimated that shareholders received an estimated $12 billion less during 1986 than they would otherwise have received without leaks in the takeover process.

Corporate Debt Attributable to Takeovers

Joining Brady and Rohatyn on the Committee's first panel of witnesses on January 28, 1987, were Alan Greenspan, now Chairman of the Federal Reserve, and Lloyd N. Cutler, a Washington attorney. Both witnesses expressed concern over the accumulation of corporate debt associated with takeovers, and Greenspan made the observation that the evidence does not support the contention that poorly run companies are the victims of hostile takeovers.

Said Greenspan, "A number of rather well run or improving companies have been the subject of successful takeovers merely because their stock prices have not yet fully reflected their improved status." He expressed further his belief that "there's no question that the sharp rise in corporate debt, and more exactly corporate fixed charges, have made the economy more vulnerable in the event of a significant contraction."

Lloyd Cutler's concerns regarding corporate debt and the implications of the steepening decline in equity-debt ratios was more explicit. He made the following observations:

> "First, as more and more corporations succumb to takeovers or successfully defend by repurchasing their own shares, the

equity-debt ratios of these companies will shift from 2/1 equity/debt to 1/2 or even 1/10 or 1/20 equity/debt.

"Second, the national average equity/debt ratio will decline from 2/1 toward 1/1 or even lower . . .

"And perhaps most threatening in the long run, all of this equity disinvestment, asset liquidation, debt creation and intermediation of people's savings is directed toward the purchase and resale of existing financial and physical assets rather than the creation of any significant new capital plant or technological research."

Cutler concluded:

"From an overall macro-economic point of view, the implications for the stability, competitiveness and growth of the U.S. economy could hardly be more ominous. It requires a remarkable tolerance for letting markets regulate themselves to view these risks with equanimity. Only those who would have opposed the creation of the SEC after the 1929 crash can consistently argue that the Government should leave the junk bond phenomenon alone."

Other witnesses expressed similar views throughout the Committee's hearings. A number of witnesses encouraged specific action to control the use of debt in takeovers or, at least, other modifications to current law which might indirectly induce a more balanced role for the use of corporate debt.

As noted, in many corporate control contests considered by the Committee, the bidder obtained loans from a bank in order to purchase the shares of the target company.* Then, to repay these loans, the bidder was forced to issue new debt under the aegis of the newly acquired company, or even sell some of the assets to generate needed cash. Similarly, in defending against a bidder, a corporation might itself issue new debt in order to purchase its own stock so as to keep it from being broken apart and sold piece by piece.

Highly publicized examples confirm the connection between corporate debt and unfriendly tender offers. Phillips Petroleum, in defense against bids by T. Boone Pickens and Carl Icahn, tripled its debt to $7.3 billion. Similarly, Unocal increased its debt from $1.2 billion to $5.2 billion after its contest with T. Boone Pickens. Goodyear now services $4 billion in debt, following a bid by British financier James Goldsmith. Owens Corning added some $2.6 billion to its debt portfolio. Recently, Chicago-based Borg Warner fended off a takeover by floating debt of some $4 billion to purchase its stock, and increased its debt loan ten-fold while Burlington Industries in-

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* In order to evade limitations on debt incurred for this purpose imposed by the Federal Reserve Board's margin regulations under Section 7 of the Exchange Act, a number of bidders have labeled their debt as "preferred stock." In two recent cases, federal district courts have found that the bidder's "preferred stock" was in economic reality debt subject to the margin rules: *Caesars World, Inc.* v. *Sosnoff*, CV 87.1622 (C.D. Cal. June 8, 1987, *vacated by settlement stipulation* November 17, 1987); *Duro-Test Corp.* v. *TCA-IV Limited Partnership*, 87 Civ 4418 (D.N.J.), Transcript of Proceedings of December 9, 1987 ("The Court finds substantial merit in plaintiff's contention that the preferred stock is tantamount to debt rather than equity, and therefore that defendants may have violated the margin regulations."). In the *Caesars World* case, the court enjoined the tender offer, finding that the target company had standing to assert a violation of the margin regulations, while the court in the *Duro-Test* case concluded that the target did not have standing to assert such a claim and therefore declined to enjoin the offer.

curred over $2.5 billion in debt to buy back its stock following a hostile takeover attempt.

Aggregate economic statistics verify that corporate debt is proliferating, and this is largely because of battles for corporate control American corporations sold $263 billion worth of debt in 1986, double the 1985 figure, and five-times the figure of 1982. In 1986, American industry spent some $177 billion on hostile bids, much of that in the form of new debt. Of particular concern to the Committee, this was the first time in U.S. history that the amount spent on hostile takeovers was greater than the amount spent on acquisitions of new plant and equipment.

Former SEC Chairman John Shad has summarized the situation as follows:

> "The greater the leverage, the greater the risks to the company, its shareholders, creditors, officers, employees, suppliers, customers and others. . . . The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow. During the past few years, the multi-billion dollar premiums shareholders have received in leveraged takeovers and buyouts have been a multiple of their losses from acquisition-related bankruptcies. The premiums come first, the consequences later."

Corporate executives also stressed to the Committee that takeover-related debt service pressures detract from needed internal investment. For example, Schering-Plough Corporation Chairman Robert B. Luciano explained that the firm's debt burden reduces the funds his company could otherwise invest in disease-curing research.

Throughout its consideration of the Tender Offer Disclosure and Fairness Act, the Committee was mindful of the views expressed regarding the relationship between certain tender offers and the accumulations of takeover-related debt.

The burdens of takeover-related debt on the entire economy are a concern to the Committee. The Committee takes seriously the implication that operation of the current law promotes quick decisions resulting in corporations shouldering enormous debt either to mount a takeover or defend against one.

Takeover Impacts on Employment and Communities

Another equally important and related issue that was repeatedly brought to the attention of the Commitee involved the impact of certain corporate takeovers on employment and local communities.

For example, the AFL–CIO adivsed the Committee in April that an estimated 80,000 member jobs have been lost to takeovers and that during the preceding 3½ year period about 500,000 workers lost their jobs as a result of takeovers and takeover attempts.

The Committee was reminded that increased debt raises operating expenses, sometimes forcing restructuring through sales of corporate assets and plant closings. For example, following a 1985 contest betyween GAF Corp. and Union Carbide, Union Carbide reduced its workforce of 96,000 by 25,000 employees. Safeway, following a hostile bid from the Haft family, eliminated some 35,000 jobs. As a consequence of a takeover attempt by Sir James Goldsmith, Goodyear closed its Kelly-Springfield tire plant in Cumberland,

Maryland, causing a loss of 1,000 manufacturing jobs in an area already suffering an unemployment rate over 10 percent.

The Committee also considered the additional indirect impact on employees from takeovers, stemming from the recent practice of using pension plan excess assets to finance or defend against such a change in control. Such short-term exploitation of pension plans is difficult to justify.

Finally, a number of witnesses observed that takeovers potentially destroy seniority and other expectations that employees build up over a period of years in a job. In many instances, the very concessions made by labor to make their company more competitive helped make the company an attractive takeover target.

Regarding the effects of takeovers on communities, a number of instances were presented to the Committee involving the closing by new ownership of profitable facilities in order to meet debt service requirements. Often, these communities have grown up around a long time corporate employer and few employment alternatives exist. The disruption to individuals, communities, and State and local governments from these actions has been well publicized. Several witnesses called on the Committee to modify current law to include, at least, disclosure requirements on a bidder to describe his plans for corporate facilities prior to the takeover.

Economic Arguments

In considering the need for tender offer reform the Committee was mindful of the economic arguments that have been made on both sides of the debate regarding the impact on investors of changes in corporate control as well as on the efficiency of target companies.

1. Impact on Investors

Many mergers and acquisitions produce lucrative short-term gains for shareholders. However, the Committee observed that it is less clear how widely distributed these profits are among all shareholders over time, and the effects of some of these transactions on bondholders and bidder shareholders.

a. Bondholders

Investors in addition to target shareholders are affected by takeovers. For example, bondholders often suffer. Takeovers and recapitalizations that substitute new debt for equity create two classes of bondholders. The new bondholders are paid interest at a rate that reflects the company's increased financial risk due to the new level of debt. The old bondholders are stuck with the old rate and incur capital losses as a result of the transaction.

This phenomenon has come to be known as "the Revlon syndrome", after one of the most publicized cases in which Revlon bondholders suffered a severe decline in value while Revlon shareholders benefitted from a takeover bid by Pantry Pride. The Revlon bonds were ultimately downgraded to speculative grade, forcing pension fund managers, who are not permitted to hold speculative grade bonds in their portfolios, to sell them at a loss.

Such precipitous drops in the value of bonds can also result from defensive restructurings. After fending off takeover bids from T.

Boone Pickens and Carl Icahn, Phillips Petroleum announced a $4.5 billion plan to exchange a package of cash and debt securities for roughly half its outstanding common stock, and to sell $2 billion worth of assets. The Standard & Poor's rating agency promptly lowered the company's senior debt rating from AA to BBB, which was accompanied by a sharp drop in the price of the bonds. Bondholders of Colt Industries, Owens-Corning and Union Carbide, among others suffered similar sharp declines.

The impact on creditors is reflected in bond ratings by Moody's Investors Services. In 1985, during a period of business expansion, Moody's lowered a record number of bond ratings. Again in 1986 credit quality declined, with downgraded industrial bonds outnumbering upgrades by a 4 to 1 margin. Ratings on 33 industrial companies fell from investment grade to speculative grade. Increased debt associated with takeovers was responsible for much of this decline.

As early as 1985, Business Week observed this effect of takeovers, noting, "The takeover and leveraged buyout craze may be a boon for shareholders, but it is slaughtering owners of high-grade corporate bonds. . . . Bondholders are emerging as the victims of takeover mania." Union Carbide's chief finance counsel Morey W. McDaniel refers to this as "bondholder ripoff."

b. Target and Bidder Shareholders

In setting forth the purposes of S. 1323 in Section 2, the Committee reaffirmed that the mandate of the Exchange Act is "to protect all investors" in recognition of the fact that target shareholders are not the only investors effected by a change in control.

With respect to shareholders of the bidder company, it has been pointed out that this group frequently suffers losses as a result of an acquisition. Studies have demonstrated that the bidder's stock price may decline by as much as 30 percent within the first year after an acquisition.

Target shareholders are generally offered a premium above the market prices prevailing before a takeover bid. The Committee noted, however, that the mere existence of such a premium does not, by itself, prove that the offer is fair or otherwise in the ultimate best interests of the shareholders of the target company. A study by Professors Margotta and Marston demonstrate that target shareholders in fact do equally well in the long-term if the bid is defeated. That is, the price level of the shares of companies which remained independent generally rose to a level equivalent to that afforded by the bidder, even after taking into account the time value of money.

This result is not surprising. As SEC Chairman Ruder pointed out in his confirmation hearing, all takeovers necessarily involve some premium over pre-bid market prices: "When we have takeovers, the difference in the market valuation between the current market and the takeover price represents what is known as the control premium. That is, that there is a payment being made by the buyers for the right to deal with the corporation in any way that they may please." This control premium, however, may not be equivalent to the long-term benefits shareholders would reap if the company remained independent or even the full value of the target

corporation's assets. As a result, the price paid in the tender offer may be substantially less than the target corporation's true value. This result is particularly apparent when the bidder finances the entire purchase price with borrowed money. In such a case, it seems clear that the bidder believes that the company's assets are worth more than the market price of the company's stock. Similar concerns have also been raised in connection with management-sponsored leveraged buyouts, in which most of the purchase price comes from borrowed funds, with the assets of the company as collateral.

Former Securities and Exchange Commissioner Bevis Longstreth and others have questioned the fairness to target shareholders of such transactions, especially regarding the inherent conflict of interest when management acts not only on behalf of shareholders as the seller, but negotiates for itself as buyer as well. This may give rise to potential conflicts of interest which put shareholders—even if they receive a premium for their shares—at an economic disadvantage compared to management.

Whether a company is acquired by a third party in a hostile tender offer or by its management in a leveraged buyout, the benefits the acquiror receives may result from a loss of value to the shareholders. Such loss may become apparent, for example, (1) when the acquiror subsequently sells assets for more than the value shareholders were paid for the company or (2) when a company is taken private and, shortly thereafter, again taken public at a substantial profit to the acquiror. Particularly under these scenarios, it is clearly an incomplete analysis to argue that the existence of any initial shareholder premium establishes that the transaction was beneficial to shareholders.

2. Corporate Efficiency

The Committee considered, but did not find compelling, the argument that it is primarily poorly-run companies that have been the subject of recent takeover activity. This argument, as mentioned, was refuted by the Committee's very first witness, Alan Greenspan, as well as by many others who followed.

Numerous studies contradict the poorly run target company theory. In a study by F.M. Scherer of Swarthmore College and David Ravenscraft, target firms were found to be "extraordinarily profitable companies." In addition, "7 or 8 years on average following a merger, profitability had declined sharply relative to pre-merger levels." Scherer and Ravenscraft concluded that "the evidence mandates considerable skepticism toward the claim that mergers are on average efficiency-enhancing." Wrote Scherer, "Takeovers frequently lead to short-run profit-maximizing strategies, eventually leaving wasted corporate hulks in their wake." Columbia's Professor Lowenstein likewise found that in a 6-year period, target firms enjoyed a 16 percent return on equity, considerably greater than that of the average firm.

William E. Wall, Chairman of the Kansas Power and Light Co. clearly summarized this point: "It isn't the poorly-managed, stumbling companies (bidders) are after. Quite the opposite. It's companies of the stripe of Phillips Petroleum, Owens, Corning, Goodyear,

Gulf Oil, ITT. When Chrysler was at the brink, in its darkest hour, its management was safe from the bidder's insults."

Balancing the subject of short-term shareholder benefit which may flow from contested corporate takeovers with the interests of other parties in the process, the Committee noted the advice of investment banker Nicholas F. Brady, who testified, "Let's not have drunk driving and speeding on our financial highways. We are, by saying there is no limit to what the shareholder can do to maximize wealth, ignoring every other part of the system."

The committee passed S. 1323 after careful review of all of these issues.

A summary of the major subject categories of the Tender Offer Disclosure and Fairness Act of 1987 is presented immediately below. These categories are divided as follows: Disclosure of Stock Purchases; Tender Offer Procedures; Greenmail; Standards for Operation of Pension Funds; Proxy Disclosure; Studies; Increased Insider Trading Penalties; Chinese Wall Procedures; Registration and Regulation of Arbitrageurs; and Respective State and Federal Roles in Regulating Tender Offers.

Catalog of Reforms

I. DISCLOSURE OF STOCK PURCHASES

A. Closing the 10-Day Window Period

To promote faster acquisition disclosure, bidders that acquire more than 5 percent of a firm's stock must disclose such acquisitions within 5 days after crossing the threshold, and may not make additional purchases of target company shares until public disclosure of the initial purchase has been made.

Timely disclosure serves as the pivotal tool for investment decisions. Disclosure of an acquisition is addressed in section 13(d) of the Securities Exchange Act of 1934. This governs those who acquire more than 5 percent of a class of registered equity security and requires them to disclose this ownership within a 10-day "window" of reaching this threshold. Among the information required by section 13(d) is the identity of the buyer; the purpose in acquiring the stock; the source of funds to make the acquisition; and any arrangements or contracts related to the stock. As conceived, this disclosure is intended to inform the market of the development and details of an imminent potential for a change of control.

However, during the 10-day window under existing law, a buyer may cross 5-percent ownership and continue to acquire stock without limit and without obligation to disclose until the 10-day period expires.

The ability to acquire so-called beachhead positions in excess of 5 percent without disclosure is evident in several examples. Sir James Goldsmith acquired 11.5 percent of Goodyear before his initial disclosure under section 13(d); Carl Icahn accumulated 20.5 percent of TWA before filing; and, Harold Simmons bought 17.5 percent of NL Industries before filing.

Once an acquisition is publicized, a company's stock price almost always rises, reflecting the "control" premium. Secret stock accu-

mulations thus can play a key role in a bidder's strategy. Should the bidder fail to win eventual control of the company, the bidder can still sell the initial beachhead, purchased at a discount, for a profit. The profit guaranteed by this secrecy is gained from unwitting shareholders who sold in the market without the benefit of any disclosure concerning the bidder's activities and plans. Some witnesses suggested that this chance for profit, even if the takeover fails, has promoted artificial bids.

A number of commentators have criticized this 10-day window. In 1983, the Securities and Exchange Commission Advisory Committee on Tender Offers found that the window presented "a substantial opportunity for abuse," and recommended that the 10-day window be closed to "provide adequate notice of the shareholder's investment and intentions regarding the issuer and [to give] time for the market to assimilate such information."

John Bachmann, the Chairman of the Securities Industry Association [SIA] testified before the Senate Banking Committee on June 24, 1987, that "SIA fully agrees that the 10-day window in section 13(d) should be closed", as did Robert F. Greenhill, who appeared on behalf of the Capital Markets Group—First Boston Corp., Goldman Sachs & Co., and Morgan Stanley & Co. The president of the North American Securities Administrators Association, Daniel F. Bell, noted that "Under current takeover rules, investors have been victimized by an acquisition disclosure system that permits unconscionable delays in providing needed information to the trading marketplace and to the investing public regarding substantial share acquisition." Indeed, virtually all of the witnesses who testified before the committee agreed that adjustment to the 10-day window was warranted.

In response, the committee adopted section 3(a) of the bill which amends the Exchange Act to require that the public disclosure of a 5-percent acquisition must occur within 5 days following the acquisition rather than 10 days. This disclosure must be accompanied by a public announcement, as described in section 5(a) of the bill, in which the bidder releases details of the bid to nationally recognized news services. In addition, under section 3(f) of the bill, a "standstill" is imposed pending disclosure. That is, the buyer may not purchase additional shares beyond the 5-percent level until disclosing the initial acquisition. If the required disclosures are made before the 5-day period expires, the buyer may thereafter resume purchasing target stock.

By reducing the maximum filing period to 5 days following acquisition of a 5-percent ownership interest, requiring a release to news services, and imposing a standstill during the 5-day period on further acquisitions until the filing is completed, more rapid disclosure to a greater number of shareholders is ensured.

This filing procedure additionally provides time for the markets to digest the information in a more orderly and efficient manner before an acquiror can secretly accumulate a large ownership block. That is, all shareholders will gain access to critical investment information in a more timely fashion, ensuring that many more investment decisions will be based on a fuller understanding of material circumstances.

B. Time for Filing Amendments

To promote timely reporting on changes, disclosure of additional acquisitions must be filed within 1 day.

In keeping with the design of requiring more timely disclosure of material information, the committee agreed that additional acquisitions should be publicized according to a specified schedule. Under current law, an acquiror who materially increases holdings in a company beyond a level previously disclosed must notify the SEC of this change "promptly." The committee found the current requirement of a "prompt" filing to be vague and to allow for a substantial lag between additional purchases and disclosure. By establishing a clear framework, other shareholders will be alerted on a timely, regular basis.

To clarify the schedule for filing amendments, the committee mandated in section 4 of the bill that an acquiror file an amendment by the close of business on the next trading day following any such material change. This section amends section 13(d)(2) of the Exchange Act.

Current law allows a limited exception for institutional investors. Many investment decisions made by this group account for blocks of stock that would otherwise require disclosure by an individual investor or bidder. Therefore the same filing requirement for this group might be overly burdensome. As a consequence, the existing exception is maintained permitting institutional investors to disclose activity at the close of each quarter and in a short form containing less information. In addition, because the bill imposes more rigorous disclosure requirements on all holders of more than 5 percent of an issuer's securities in order to obtain enhanced disclosure concerning transactions presenting a potential change in control, the Commission may determine to extend the exception afforded institutions to other classes of investors who do not acquire securities for the purpose of influencing control.

C. Insider Reports

The bill also requires company managers and other insiders to disclose trading activity on a more timely basis. Under current law, insiders are required to report changes in ownership within 10 days after the close of each calendar month. To make sure that the public is made aware more quickly of how company managers are themselves trading, corporate insiders must disclose such trades within 5 days after the trade itself. This statement would include the trade, the level of prior ownership, and the level of resulting ownership. This change is contained in section 13 of the bill, which amends section 16(a) of the Securities Exchange Act of 1934.

D. Disclosure of Control Intent

To promote early disclosure of a takeover bid, an acquiror must detail its intentions. To discourage false or ambiguous filings, a bidder who claims that an acquisition is a passive investment cannot mount a takeover bid until 60 days after disclosing a control intent.

Along with disclosure of the shares acquired, the intentions of the acquiror are of vital interest to investors. Currently, however, statements of purpose in this regard are frequently drafted to be purposely ambiguous.

F. Daniel Bell, President of the North American Securities Administrators Association, told the committee that "current Federal disclosure regulations have permitted misleading or incomplete disclosures by acquirors regarding such a critical issue as their intentions regarding control. Current regulations fail to accord adequate remedies for investors victimized by acquirors who file ownership information disclosures containing misrepresentations or material omissions."

Takeover bidders who accumulate beachhead of stock often claim that they are purchasing merely "for investment" in order to permit them to continue to buy additional shares after making a section 13(d) filing without causing an increase in the target company's stock price.

For example, a California Federal court found that T. Boone Pickens falsely claimed in his original schedule 13D report of his Unocal holdings that they were "solely for investment". After filing that report, Pickens continued to purchase additional shares. Approximately four weeks after filing an amended report claiming only an investment intent, Pickens filed a new report disclosing that it was considering acquiring control. Two weeks later, he launched a takeover bid for Unocal.

Such false statements have been found by courts in numerous other cases in recent years, demonstrating that this is a significant and widespread problem.

An equally important problem is calculated ambiguity in disclosures, intended to cloud the bidder's true intentions.

For example, in May 1985, Carl Icahn filed his initial schedule 13D as to TWA stock, reporting that he had "acquired [TWA] shares * * * in order to obtain an equity position in the Issuer," that he was "evaluating" his position and might "explore * * * seeking control," "acquiring additional shares * * * from time to time." or "dispos[ing] of shares." He also "noted that [his] possible activities" were "subject to change at any time." Approximately 1 week later, Icahn made a proposal to the Board of Directors to acquire the company. He continued to make purchases in the market, and by September 1985 he controlled more than 52 percent of the stock.

When Irwin Jacobs filed a schedule 13D with regard to Borg-Warner Corp., on October 30, 1986, he stated: "The Purchasers consider their equity position to be an investment." He also stated that he might "purchase additional shares from time to time," might "under certain circumstances consider seeking control," might "explore the feasibility of, and strategies for, seeking control," or might "attempt to dispose of shares * * * in the open market, in privately negotiated transactions, or otherwise." In late November 1986, only three weeks later, Jacobs proposed to Borg-Warner's Board that he acquire the company, and later threatened to make a hostile offer. Jacobs, who had continued purchasing Borg-Warner shares, then sold his block to Bear, Stearns for a reported $8.3 million profit.

The numerous lawsuits that have resulted in a court-ordered correction of an inaccurate disclosure of purpose demonstrates that current law has not ensured accurate and meaningful disclosure of an acquiror's purpose. This shortcoming is addressed by this section.

To correct the potential for ambiguity, the committee established in section 3(d) of the bill a requirement for a straight-forward statement of purpose by the acquiror. The statement must make clear whether the purpose of the acquisition is for investment only, or whether it is part of a plan to influence control of the corporation. It is anticipated that the Commission will, in ensuring that a bidder disclose whether he is acquiring securities for passive investment purposes or for influencing control of the issuer, provide appropriately labeled boxes on the schedule 13D reporting forms, which would require the filing person to indicate the purpose of the acquisition by checking the appropriate box.

Current law provides little guidance on the consequences of a shareholder changing intent from investment to control when purchasing the shares of a company. While the Federal securities laws forbid misleading statements, it is difficult to adjudicate the sincerity of a shareholder who claims to be a passive investor, but who then makes a takeover bid. In practice, when a misleading statement is identified, the penalty generally is simply a corrective disclosure. That is, there is little motivation for accurate disclosure of intent.

To encourage accurate statements of intent, section 3(d) will operate in close coordination with section 5 of the bill. Section 5 prohibits a tender offer for 60 days by any person who indicates a passive investment purpose pursuant to section 3(d) and then delcares an intent to purchase control of the firm. Because of the time value of money, many bidders are unlikely to cite misleadingly that investment is their intent, and then wait 60 days before commencing a takeover. The choice of 60 days reflects the committee's determination that such a period would thwart bidders who might have planned to mislead the market. At the same time, the bill provides an exception for investors where there has been a material change in circumstances since the time of their original filing.

Several industry experts agreed with the need for an enforced standstill following a change of intent, including Robert F. Greenhill, managing director of Morgan Stanley, who spoke on behalf of the Capital Markets Group.

Bidders will also be discouraged from filing a false statement of intent as a result of the civil liability provisions under section 6 of the bill.

E. Tighter Regulation of Group Activity and Fuller Disclosure of Communications During 30 Days Before Acquisition

To discourage informal groups from trading outside the disclosure rules, the restrictions on group activity are clarified and tightened. Also, when disclosing an acquisition, buyers must disclose communications during the 30 preceeding days.

When the Securities Act of 1933 and the Securities Exchange Act of 1934 were originally adopted, one of the primary problems ad-

dressed was the so-called investment pool. The Senate Banking Committee hearings at that time uncovered large investors acting in concert to manipulate the market to their advantage at the expense of small investors. Accordingly, the securities laws established the principle of disclosure of material information as a means of regulation to promote market fairness and integrity.

Under current law, disclosure and other requirements apply to those who are acting in concert. The committee has observed, however, that during the last several years bidders have evaded the spirit of the law with respect to disclosure of the complete identity of those engaged in a takeover bid. Modern pools, composed of investment bankers, institutions, arbitrageurs and others who join an acquiror in takeover activities, increase the potential for market manipulation. These entities represent potent allies to an acquiror and they are proper subjects of disclosure.

An additional shortcoming of current law in this area is that it does not require the acquiring party to disclose any communications prior to filing the schedule 13D regarding plans to purchase a large ownership stake. While agreements or understandings with respect to the securities must be disclosed, disclosure of prior communications is not required, no matter how extensive such communications may have been.

The concerns expressed in this area to the committee by several witnesses included group activity which resulted in certain companies being "put into play." General Mills Chairman H. Brewster Atwater, Jr., alleged the following:

> "Takeover bidders . . . act collectively to evade the reporting requirements until they have accumulated enough stock. If each person's holdings in a target remains below 5 percent, by not admitting that they are acting together as a 'group,' takeover bidders and arbitrageurs can significantly increase the amount of stock they control and continue to buy in secret from unsuspecting shareholders without reporting under Section 13(d). Unfortunately, without disclosure of agreements and contacts between members of such a group, it is extremely difficult to detect and prove that the group is operating when it engages in secret collusion."

On occasion, group activity has involved clear and outright violation of laws. In two cases so far this year, the Government has brought charges alleging illegal arrangements to "park" stock with one another to conceal the stock's true ownership. In late January, Michael Davidoff, Boesky's chief trader, pleaded guilty to criminal charges that he had parked stock through bogus trades with Seligman, Harris & Co., a London broker. The purpose of the trades, according to the charges, was to evade Federal laws designed to protect investors by requiring brokers to maintain minimum amounts of capital. Additionally, according to the recent SEC complaint against Boyd Jefferies, Jefferies parked securities on behalf of Boesky's Seemala Corp. which, among other things, permitted Seemala to cricumvent its section 13(d) reporting obligations. Shares parked included the securities of Pioneer and Phillips Petroleum, both of which were takeover targets.

An indication of the extent of this type of illegal activity was provided in the Government's sentencing memo on Boesky which

said, "Jefferies has confirmed Boesky's revelation of criminal accommodations for valued customers, a practice that apparently is deeply rooted in the brokerage industry."

To imporve the accuracy of disclosure, the committee agreed to clarify the statutory definition of a group, to reaffirm current case law, and to require disclosure of communication that takes place prior to filing.

Specifically, section 5(a) of the bill makes explicit the congressional intention that the definition of a "person" includes two or more people who act together, whether or not they are formally bound by a contract. The improved disclosure resulting from this renewed emphasis on strict enforcement of the group concept will assist in providing the market with information on modern investment pools which can operate without detection under current law.

Where a filing is made, section 5(a) also will enable the market to obtain early identification of persons who may have shared intentions with respect to the acquisition of a specific company's securities by requiring disclosure of their communications. Section 3(b) of the bill requires identification in a section 13(d) filing of any person with whom discussions were held regarding the acquisition any time within the 30 days prior to filing. This covers only communications with other large shareholders, namely those who have filed 5 percent disclosure statements or who the buyer knows has agreed to purchase stock in connection with the communication. Only the fact, and not the substance of the communication, need be detailed.

An exception is provided for communications by or with a broker or dealer acting in the ordinary course of business, provided that the broker/dealer does not own sufficient target stock, either alone or as part of a group with clients or others, so as to require those holdings to be reported under section 13(d) or section 13(g) of the Exchange Act. This exception is designed to eliminate possible undue burdens or brokers and dealers who, in the ordinary course of business, engage in numerous conversations with shareholders and prospective investors as part of their regular course of business but they are conversations which do not relate directly or indirectly to influencing or effecting a takeover or change in corporate control. Examples include discussions between retail brokers and their clients and between analysts and the investing public which are unrelated to influencing or effecting a takeover or a change in corporate control.

Disclosure of the fact that a person discussed plans to acquire a large position in a particular company with a person described in section 3(b) of the bill will provide other shareholders and the markets with more complete, material information.

The scope of disclosure required under this provision has been carefully tailored to require identification of only those likely to be acting in concert. Those who choose not to invest need not be identified. Moreover, the 30 day period covered by the section is not overly burdensome since it is designed to require disclosure only of communications which could have resulted in tandem purchases. This section of the bill requires nothing more than disclosure of communications; if the communication is legitimate then there should be no reservations about disclosing its occurrence.

F. Daniel Bell, of the North American Securities Administrators Association, said the bill "effectively deals with the problems associated with delayed and misleading 13D ownership information filings. Under this legislation, the prospects for full and timely disclosure would be enhanced with provisions that * * * expand the required disclosure information to include identification of persons with whom the acquisitions were discussed."

F. Financing Disclosure

Additional details are required of the purchaser regarding the financing of an acquisition.

Section 3(c) of the bill provides for improved disclosure from current law on the financing arrangements used to acquire the securities which are the subject of the filing. Under current section 13(d)(1)(B) of the Exchange Act, disclosure is required of the source and amount of funds used, or to be used, to acquire the subject securities, the identity of the lender, and a description of the transaction. The new provision adopted by the committee expressly requires a broader summary of the financing agreements relating to any extension of credit for funds used (or to be used) to make the disclosed stock acquisitions, including: the identity of the parties, the terms, collateral and effective interest rates of the credit, as well as disclosure of all fees paid or to be paid to the persons providing or arranging for the credit, and all other material terms or conditions of such credit.

This additional financing information will assist the market in identifying spurious bids. It will also discourage efforts to put target companies into play based on suspicious or unsound financing arrangements, and will assist investors in more accurately assessing and reacting to a potential acquisition.

Under current law and practice, information disclosed is not as comprehensive and meaningful as it should be regarding plans to repay the considerable debt frequently associated with acquiring an ownership stake. Moreover, specific plans of the acquiror to dispose of the target's assets or restructure the target in order to repay the debt will likely be of interest to a number of shareholders and may affect how investors react to the disclosure.

G. Fee Disclosure

To help prevent conflicts of interest among investment bankers, lawyers, and lenders and to help investors decide what role investment advisors and lenders play in an acquisiton, fees must be disclosed.

Current law requires disclosure of contracts, arrangements or understandings which the filing party has with other parties with respect to securities of the issuer, but has no specific requirement that the filer disclose all fees paid—or to be paid—to investment bankers, lawyers or accountants. Section 3(e) of the bill requires disclosure of fees to be paid to advisors. Under this new provision, fees paid—or to be paid—to lenders or others in connection with purchases of the stock that is the subject of the filing also must be disclosed.

This additional disclosure of fees required by the bill will serve to limit the impact of potential conflicts of interest. It will also help assess allegations that have been raised periodically that the high fees associated with merger and acquisition activity may have been at least partially responsible, in some instances, for certain deals going forward which otherwise may have lacked merit. Currently, investment bankers, takeover lawyers and lenders have strong financial incentive to create or go forward with deals regardless of their economic or other merits.

Fees associated with corporate takeovers have continually grown. In 1977, manages at United Technologies employed the investment banking firm of White, Weld & Co. to help in a bid for the major engineering firm of Babcock & Wilcox. The fee, which is assumed to have been adequate compensation, was $20,000. In contrast, during the Texaco-Getty takeover in 1984, a Harvard Business School professor figured that one investment banker earned $127,000 an hour for his labor. According to the Congressional Research Service, lawyers and investment bankers have earned a collective $7 billion during the 1980's in services rendered during takeovers.

Not surprisingly, many investment banking firms openly promote mergers.

In October, the world's stock markets gyrated with extreme volatility. While many underlying factors contributed to this problem, such as the nation's debt and computer-driven trading programs, some commentators pointed to corporate takeovers. Entrepreneur H. Ross Perot noted the following in a Washington Post column, dated October 25, 1987:

> "The endless orgy of raids and takeovers had a lot more to do with making large fees and personal profits than with revitalizing corporations * * *. Junk bonds, which by definition are junk, will be worn like anvils around the necks of both companies and junk-bond buyers for years, and will cause significant damage to our economy. Any industry which can afford to pay 28-year-old boys $500,000 to $1 million a year for unproductive work on Wall Street sends a signal to the world that its fees are excessive."

By requiring more complete and accurate disclosure of fee arrangements, shareholders and other investors will have access to important information bearing on the tender offer process and the parties involved.

Also, under section 3(g) of the bill, section 14 of the Exchange Act is amended to require disclosure of fees and expenses by management in connection with any solicitation or recommendation to the holders of a security to accept or reject a tender offer.

H. Civil Liability for Violation of Disclosure Requirements

To discourage inaccurate and untimely filing, penalties for disclosure violations are increased.

Currently, penalties for disclosure and other filing violations are inadequate. The SEC has the power to invoke some remedies against violators who fail to file or who file a false or misleading statement. However, this remedy usually takes the form of injunc-

tive relief or an administrative proceeding merely requiring the violator to refile properly.

The committee found that these current penalties are not a sufficient safeguard against infractions of the law. Currently, if a security holder is injured, and the SEC does not act, that private litigant faces substantial obstacles to secure injunctive relief. If the SEC is to deal successfully with filing and disclosure violations, the penalties must be appropriate to the illegal activity. A stiffer penalty would not only encourage the SEC to bring cases but would also alert potential violators that they run a significant financial risk for making false or late filings or otherwise violating the law.

Section 6 sets forth civil penalties in addition to those currently available for violations of subsections (d), (f), and (g) of section 13, section 14, or subsection (a) of section 16 of the Securities Exchange Act of 1934. Specifically, a court can impose a penalty of up to 3 percent of the value of the securities that are the subject of the violation, for each and every day of the violation, subject to a maximum aggregate penalty of 50 percent of the value of the securities in question.

Also, the bill expressly codifies the power of the courts to enjoin any tender offer or grant other appropriate equitable relief as an additional means of enforcing the disclosure rules. Since the courts generally have limited relief to corrective disclosure, the bill makes clear that additional equitable relief, such as divestiture or sterilization of voting rights, is also often appropriate and may be necessary to effective enforcement, in Commission as well as in private actions. Finally under section 6 of the bill, courts may grant appropriate equitable relief in civil injunctive actions for violations of sections 7, 13(d), 13(f), and 13(g) of the Exchange Act.

In recent congressional testimony, SEC Chairman David Ruder stated that penalties for violations of section 13(d) would, "in appropriate circumstances, be a useful addition to existing remedies * * *. The legislation should set maximum penalty up to which courts would be able to determine an appropriate amount. This would take into account varying degrees of culpability and give the Commission greater flexibility in ensuring compliance with the filing requirements. In setting the statutory maximum, however, it should be noted that if the penalty is set too low it may be viewed simply as a minor incremental cost of doing business and thus would not serve as an effective deterrent."

II. TENDER OFFER PROCEDURES

Sections 13 and 14 of the Securities Exchange Act of 1934, as amended by the Williams Act, govern most of the mechanisms of the tender offer process. Essentially, these sections and the attendant regulations require that tender offers be accompanied by full disclosure of the material terms of the bid and establish certain procedural requirements for the conduct of tender offers.

A. Tender Offer Period

To give investors additional time to consider a bid, the minimum tender offer period is lengthened from 20 business days to 35 business days.

By current SEC rule any tender offer must remain open for at least 20 business days. A number of witnesses representing a range of interests testified in favor of an extension of the minimum offer period in the tender offer process. Thomas R. Donahue, representing the AFL–CIO, urged that "stockholders should be given a longer period of time to respond to tender offers." Felix G. Rohatyn, senior partner, Lazard Freres & Co., advised the Congress to "lengthen the tender offer period to 60 days". Anthony J. Celebrezze, Jr., representing the National Association of Attorneys General, said he believes "that at least another 5 business days should be added to the bill's 35 days, for a total of 40 business days. This would provide a little less than 2 calendar months, which is not an excessive amount of time when the fates of thousands of people are being decided. An even longer minimum period may be advisable." Alexander B. Trowbridge, representing the National Association of Manufacturers, recommended that the tender offer period be raised from 20 business days to 60 business days. Donald C. Clark, representing Stockholders in America, suggested 90 days. H. Brewster Atwater, Jr., representing the Business Roundtable, recommended 40 business days. Alvah H. Chapman, Jr., the Chairman and Chief Executive Officer of Knight-Ridder, Inc., suggested simply that Congress should "stretch out the time of tender offers to provide a longer decision time for shareholders to decide". And a number of witnesses representing the States recommended more than 40 business days because, as one of them put it, "Public investors are victimized by a rush-to-judgment procedure and mentality forced under the current 20 day minimum offering period."

The committee understands that it may be in the interest of the bidder to minimize the time that an offer is open. Among other things, a lengthy offer period invites counter offers, or permits other circumstances to develop that could deter the attractiveness of the bid.

Yet for essentially the same reasons, it is in the interest of shareholders that the offer period be increased. An extended offer period may attract other bidders, enhancing the auction market, and consequently raising the price for the stock.

The decision whether or not to tender shares to a bidder turns on complex information. With the increasing complexity of tender offers and offering documents, the committee found that 20 business days is too short a time for shareholders to be able to read and digest all of the information and make reasoned decisions.

This is particularly true for investors with relatively small holdings who may lack the fast access to analysis available to institutional holders.

In addition, target boards do not currently have sufficient time to respond to takeover bids and find other alternatives in the interest of shareholders. In fact, many boards resort to measures counterproductive to their companies, their shareholders and the economy by filing questionable lawsuits, or assuming unnecessary levels of debt. The committee also sympathized with the argument that it is unfair to allow a company to be taken over in 20 business days—sometimes by someone who has little to no previous experience in the business—when often it has taken more than 20 years to build that company.

B. Tender Period for Firms with Employee Ownership

To protect and promote firms with employee ownership, the tender offer for such firms must remain open 95 business days to give employees a chance to mount a counter-bid.

In considering the tender period the committee separately addressed the special case of a company where the shareholders are also employees of the company and organized as an Employee Stock Ownership Plan. There have been a number of takeovers involving employee-ownership, either where a firm with considerable employee ownership was sought, or where a firm defended against a bid by increasing employee ownership.

The committee agreed that employees are among the most important constituents of corporate America. Appearing before the committee, former Senator Russell Long stressed this point: "Employees' jobs are often endangered by the enormous debt that generally accompanies these transactions; yet employees seldom have an opportunity to gain a stake in the ownership being financed with that debt. I believe employees are a corporation's natural shareholders."

In a number of instances brought to the attention of the committee, employee/owners explored the possibility of purchasing the company themselves. However, lacking management experience, and lacking the experience in corporate takeovers that the bidding party enjoyed, these employee/owner groups were often at a disadvantage in negotiating appropriate financing contracts necessary to undertake a takeover.

Specifically, the committee considered the case of Eastern Airlines. While this company was not sold through a tender offer, it served to illustrate that ample time to mount a bid is important. Employees of the transportation company had demonstrated their interest in the acquisition and at one point, had accumulated approximately 35 percent of the company. They were engaged in retaining appropriate legal and investment banking advice, when the company was sold to an outside bidder, led by Frank Lorenzo.

F. Lee Bailey, lead trial counsel for the Eastern Airlines Coalition, recommended in testimony to the committee on June 26, 1987, that companies with employee ownership "ought to have a special classification where it cannot be taken over just because Frank Lorenzo gets his hands on 51 percent of the other stock and with one fell swoop and only one vote wipes out the employees who come too late to court to enjoin him and never had the chance to put their money on the table.

Other witnesses also pointed to the problem of time. Robert Strickland, chairman of Lowes Companies, Inc., testified how his company is vulnerable to a hostile takeover. Lowes is 22 percent owned by employees, and 31 percent owned by 10 financial institutions, with the balance owned by smaller shareholders. But time is on the side of the institutional investor. As Strickland explained to the committee:

> "How different [from employee owners] is the timeframe of institutional investors about whom I have said that * * * long term is next Friday at 4 p.m. Beyond separate timeframes, the dice are loaded against employees. Consider that an offer and

SEC filing can be made, an ad run in the Wall Street Journal, and then 10 telephone calls to 10 institutions can be made, and they own 50 percent more shares than our total employee work force. The information would have to go to our ESOP trustee and he and management would have to notify the employees in 300 locations. They would have to try to understand the offer, talk to advisers, and mail in their answers. And in the even of a partial tender offer, for just a portion of the stock at a high price, it's clear the institutions are equipped to make those decisions with lightning speed and our employees are not. They would make those decisions before our employees ever got their mail from the postmaster."

Senator Long stressed that, "at the very least, they should be provided sufficient time to put together a competing bid."

In accordance with this recommendation and to afford employees a greater opportunity to effect their own fate in the tender offer process, the committee lengthened the mandatory minimum tender offer period by 60 business days when employees have a qualified employee stock ownership plan and make a substantially equivalent offer to other offers made for the company.

The committee agreed that this provision would apply only to companies whose employees control a significant portion of stock, defined as more than 10 percent. Currently, this would mean that about 50 firms with publicly traded stock would qualify. While 87 percent of the Fortune 1,000 firms have some form of stock ownership plan, including a savings plan which invests in the company's own stock, more than 90 percent of these plans hold less than 5 percent of total corporate equity.

In light of the substantial body of research showing employee-ownership is associated with greater productivity and profitability and that most ESOP's are instituted in successful companies, the committee believes that the benefit to be gained by encouraging increased employee ownership in American corporations outweights any potential costs that may result from fewer hostile takeovers by an outside party.

C. Tender Offer Threshold

To maximize the number of shareholders who earn a premium from a takeover, bidders are required to tender for any shares they wish to purchase above 25 percent of the company, subject to certain exceptions.

Tender offers subject to the pro ration and other requirements of the Williams Act provide a fair means for shareholders to share equally in the "control" premium associated with a change of control. The committee reviewed evidence that payment of this control premium can be circumvented. One method is through so-called "creeping tender offers"—that is, the implementation of a concerted program to acquire control through open market or privately negotiated transactions, often undertaken in secrecy. A companion tactic is known as the "street sweep," where a bidder prematurely terminates a tender, and immediately purchases the shares again on the open market. This tactic was employed by hostile bidders in Hanson Trust's acquisition of SCM Corp.; and Campeau Corp.'s ac-

quisition of Allied Stores Corp. The Second Circuit Court of Appeals, in *Hanson Trust PLC* v. *SCM Corp.*, 774 F. 2d 47 (2d Cir. 1985), held that this strategy did not violate, and was not subject to, the Williams Act. The committee agreed that bidders seeking to purchase target shares that, when, aggregated with shares already owned by the bidder, would give the bidder more than 25 percent of a company's shares should be required to make such purchases by a tender offer subject to the Williams Act. The bill therefore will provide all shareholders with the increased value of their stock—the control premium—normally associated with a takeover.

Industry experts from virtually every sector endorsed requiring bidders to tender beyond a certain threshold of open market acquisitions. For example, Nicholas F. Brady, chairman of Dillion Read & Co., and former Republican Senator from New Jersey testified that "There is something unfair when a bidder acquires control in the open market without paying a control premium and without offering all holders the ability to sell at the same price." He went on to state his belief that " 'control' is, in effect, an asset of the corporation that should be transferred only in the light of day, with all holders—particularly the unsophisticated ones—having the opportunity to share in the proceeds." Brady suggested, "Anyone increasing his ownership to over 20 percent—whether by 1 percent or 10 percent or by 80 percent—of an issuer's stock should be required to do so in a public tender offer."

Others took similar positions in support of a tender offer threshold.

The Capital Markets Group—representing The First Boston Corp., Goldman Sachs & Co., and Morgan Stanley & Co.—asserted that open market purchase programs in a change of control situation "deny shareholders the premium price that usually is required to purchase a controlling block of shares, and exclude most shareholders, usually the less sophisticated ones, from the opportunity to sell their shares to the control-seeking purchaser. To assure that all shareholders have such an opportunity, acquisitions over 20 percent should trigger the protections of the tender offer process, including the right of all shareholders to tender their shares for an equal price."

The chairman of the Securities Industry Association, John W. Bachmann, testified that "in order to prevent 'creeping tenders' that acquisitions over a stated maximum should be made pursuant to a tender offer. SIA has suggested a 20-percent maximum; the bill proposes a 15-percent maximum. Again, the differences are slight and SIA endorses this approach."

H. Brewster Atwater, Jr., representing The Business Roundtable, recommended that purchases of "shares beyond a 15-percent threshold be made by a tender offer for any and all of the outstanding shares. This would at once deal decisively with partial and two-tier tenders, and would also take care of phony tenders and sweeping the street."

Representing the Nation's largest private pension system, James S. Martin, executive vice president and chairman, CREF Finance Committee, College Retirement Equities Fund, testified before the committee that "we strongly favor the provision of the proposed legislation which effectively prohibits 'creeping tender offers' and

'street sweeps' by requiring that all acquisitions of more than 15 percent of a corporation's stock be made by means of a tender offer available to all shareholders. We see no useful purpose in the creeping tender offer or street sweep, acquisition techniques which, by their nature, are not available to all shareholders, and primarily benefit only the professional investor or arbitrageur. In fact, we have found that even with our substantial resources, we have been unable to benefit from street sweep situations, and the small shareholder is left out in the cold altogether."

And, finally, the SEC Advisory Committee on Tender Offers recommended in 1983 that, "No person may acquire voting securities of an issuer, if, immediately following such acquisition, such person would own more than 20 percent of the voting power of the outstanding voting securities of that issuer unless such purchase were made (i) from the issuer, or (ii) pursuant to a tender offer. The Commission should retain broad exemptive power with respect to this provision."

The committee agreed with these views and decided that establishing a threshold above which a bidder must tender for additional shares will ensure that shareholders are treated more fairly in potential change of control situations than is currently the case.

While the original draft of the bill required a tender beyond 15 percent, the committee-approved new Section 14(d)(5)(A) of the Exchange Act provides that any person who wants to purchase more than 25 percent of a target's shares must do so by means of a tender offer. New section 14(d)(5)(B) of the Exchange Act—section 7(b) of the bill—will create a series of specific exemptions for transactions that are not believed to present the same abusive characteristics as those discussed above. It also authorizes the Securities and Exchange Commission to create further exemptions which it determines to be consistent with the public interest and with section 14(d)(5) as a whole.

Unlike the so-called "English rule," the section will not require the buyer who wishes to exceed the 25-percent threshold to bid for all outstanding shares. It will, however, afford to every shareholder, by means of the tender offer process, a pro rata opportunity to participate in the "control premium" being offered for such number of shares as the accumulator seeks.

III. GREENMAIL

To eliminate the practice of "greenmail", any premium offered to a shareholder with more than 3 percent (who has not held those shares for at least one year) must be offered to or approved by all other shareholders.

Under current law, the ability of a target company to repurchase shares from dissident shareholders has created an incentive for persons to acquire blocks of shares of a company with the intention of reselling the block back to the company at a profit. This practice has become known as the payment of "greenmail." According to a study conducted by the Office of the Chief Economist of the Securities and Exchange Commission, from January 1979 to March 1984 approximately $5.5 billion was paid by issuers to repurchase blocks

of stock from individual shareholders, at an aggregate premium of more than $1.0 billion. Much of this premium went for geenmail.

There is evidence that a number of recent takeovers have been generated by acquirors who put companies "in play" by purchasing blocks of stock with the sole intention of selling such blocks either back to the issuers in greenmail transactions or to third parties. This form of activity has led to corporations incurring unhealthy levels of debt, engaging in unnecessary corporate restructurings, and laying off productive employees.

The greenmailer or "financial entrepreneur" often has no other intention than to blackmail the issuer into purchasing his shares at an exorbitant price. The Committee found this a pernicious abuse because the profit realized in a greenmail transaction comes directly from the target company and its remaining shareholders. Empirical evidence suggests that nonparticipating shareholders suffer substantial and statistically significant share price declines upon the payment of greenmail.

Presently, payments of greenmail are judged under the state law "business judgement rule" standard, the primary focus of which is the fiduciary duty of a company's board of directors to the company and its shareholders. Under that standard, as applied in most States, absent self dealing or bad faith on the part of target company's directors, the making of a greenmail payment generally has been deemed to be properly within the discretion of the target's board. Indeed, directors could well be serving the best interests of a company and its shareholders by eliminating, through the payment of greenmail, a divisive and hostile shareholder whose primary purpose is to reap short-term profits by generating takeover interest in a third party or by causing sufficient turbulence among company's management that it becomes cheaper and more efficient for the company to buy off the person.

Recognizing the inherent problems associated with greenmail, the committee approved section 8 of the bill which empowers an issuer to sue to recover greenmail profits obtained by any person who had beneficially owned 3 percent or more of the outstanding amount of such securities for less than 1 year, unless such sale previously was approved by the affirmative vote of a majority of the issuer's shareholders or was made pursuant to an offer open to all of the issuer's shareholders. Any such action must be brought no more than 2 years after the date such profit was realized. In addition, an issuer's shareholders are given derivative rights to sue to recover greenmail profits on behalf of the issuer if the issuer either fails to bring the action within 60 days after a shareholder so requests or fails diligently to prosecute the action.

The SEC is given the authority to exempt conditionally or unconditionally any person, security or transaction from the provisions of this section by rule, regulation or order. The committee believes that the Commission should exempt specific transactions or types of transactions that do not present the potential for abuse of the takeover process that the legislative language is designed to address. Among the exemptions which the committee believes the Commission should consider are exemptions for sales of shares held by an estate for less than 1 year where the decedent had been a long-term shareholder; shares resold to an issuer which had been

purchased in a negotiated transaction directly from the issuer; shares sold to an issuer by a former officer or employee of a company in connection with such person's retirement or dismissal, and shares sold to an issuer in anonymous market transactions where there is no reason to believe an evasion of the statute is occurring.

The purpose of the proposed legislative language is to remove the financial incentive for a person to seek greenmail from a target company. The remedy invoked in the proposed legislative language is similar to the disgorgement provision currently in effect under section 16(b) of the Exchange Act, under which a company can sue to recover profits made by its insiders from transactions in its stock within any 6 month period. The focus of the legislation thus avoids an unnecessary intrusion on the ability of States to regulate internal corporate governance. It eliminates the ability of a greenmailer to profit from his actions instead of regulating the activities of the target company.

Prohibiting the payment of greenmail was endorsed overwhelmingly in testimony before the committee. The Securities Industry Association, represented by Bachmann advised the committee that "the SIA endorses the elimination of greenmail as an abuse which is utilized by both bidders and management and which diminishes the value of shareholdings." Robert F. Greenhill, representing the Capital Markets Group, said greenmail "creates an incentive for bidders to make offers for companies that they have no real intent of acquiring and undermines investor confidence in the integrity of corporate control contests by raising questions concerning the bidder's intent in making an offer. In any event, greenmail serves no valuable economic function and therefore can be eliminated easily without impairing the markets." And investment banker Felix Rohatyn urged the Congress to "outlaw all forms of greenmail" as the premier priority in reforming the takeover process.

IV. STANDARDS FOR OPERATION OF PENSION FUNDS

Pension funds play a central role in the stock market. According to a report by the Congressional Research Service, "Institutional investors have become increasingly large and powerful influences in the securities markets and in corporate governance. Their role in the recent wave of large-scale mergers has become more conspicuous as they have been courted by both proponents and opponents of such mergers. Controversy remains on the relative amount of benefit or harm institutional investors now exert on stock market transactions and on the management of corporate enterprise."

By some accounts, institutional investors dominate the market. In 1983, a Paine Webber Inc. analyst claimed that institutions were responsible for 65 percent of the volume on the New York Stock Exchange. By 1987, this share has grown to more than 70 percent.

Moreover pension managers have increasingly adjusted their portfolios to temporary market changes. Pension fund portfolio turnover has surged, according to statistics from the Department of Labor. In 1974, approximately 20 percent of the average portfolio changed during the year. In the mid-1980's, more than 60 percent of the portfolio changed each year.

A. Long Term Perspective

Pension managers are specifically permitted to consider the long term prospects of a firm in considering the merits of a tender offer.

Currently, the Employment Retirement Income Security Act, [ERISA], is silent with respect to the specific fiduciary duty of plan trustees in the face of a tender offer. General standards mandate that trustees discharge their duty with the care of a "prudent man" and "solely in the interest" of the plan's beneficiaries.

The bill makes it clear that ERISA plan trustees may take into account both long- and short-term interests of plan participants and beneficiaries in voting upon tendering into a tender offer, and that the taking into account of long-term interests would not constitute a violation of the "prudent man" standard.

Specifically, the purpose of section 10(a) of the bill is to make it clear to pension plan fiduciaries that, when making a decision on whether to tender the shares of a portfolio company or on how to vote shares of a portfolio company in connection with a proposed change in control, the fiduciary is required to consider the long-term interests of plan participants and beneficiaries as well as possible short-term gains to the plan. The focus of a pension plan fiduciary should include the long-term health and growth of the pension fund, which frequently is dependent on the long-term potential of the plan's portfolio companies and the effect of an acquisition on the plan's beneficiaries' employment.

While this clarification may appear subtle, it is important because of the extraordinary role played by institutional investors in the marketplace.

Many pension managers are concerned about legal liability should they not tender to an acquiror that offers a premium. In one case, *Danaher* v. *Chicago Pneumatics,* 7 EBC 1616 (May 13, 1986), there is dicta that some interpret to mean that trustees are virtually required to tender in the face of a takeover bid. In another case pitting Eastern Airlines against its employee stock ownership plan, Eastern attorneys argued that ERISA required the ESOP trustee to tender. Consequently, an explicit statutory clarification is important to confirm that trustees have the ability to consider the long-term outlook.

This confirmation, however, shall not be construed to constitute complete immunity from liability. This change simply permits the fiduciary to consider the long-term consequences and prospects of an investment without fear of being deemed to have per se violated its fiduciary duty.

B. Excess Pension Plan Assets

To protect employee pensions, pension surpluses may not be used to finance takeovers or leveraged buyouts by bidders or targets.

Under current law, private pension plans are essentially a voluntary contract instituted between management and employees. With the adoption of ERISA, certain restrictions were instituted, in large part, to make sure that pension plans are fully funded and insulated against a risk of loss. However, many firms have chosen to ter-

minate plans in order to capture the so-called surplus above what is necessary to meet legal obligations.

Since 1980, an increasing number of pension plans have been terminated so that managers can tap the surpluses. Generally, the pension plan is reconstituted without the surplus. From 1981 through 1986, a total of 1,450 pension plans were tapped for a collective $16.5 billion in surplus funds, according to the Employee Benefit Research Institute.

Many of these terminations were directly related to takeover financing, including A&P, Dan River, Harper & Row, United Air Lines, Union Carbide, Raymond International, St. Regis Corp., Getty Oil Co., Superior Oil Co., Lyon Metal Products Inc., Dr. Pepper, U.S. News and World Report, Jonathan Logan, Inc., Purex Industries Inc., Times Mirror, Cities Services Co., American Stores, Co., AMAX Inc., and Diamond Shamrock Corp.

Earlier this year, Connecticut-based Schick Inc. tapped some $20 million in the surplus of the pension plan at the Reeves Brothers textile firm, which it had acquired. Apparently, this surplus had been pledged by Schick as collateral against a $100 million loan it used to purchase Reeves. Under considerable public and congressional pressure, Schick eventually restored the surplus to the pension fund.

According to concerned labor experts, many other firms have siphoned pension surpluses either to shore up defenses against a pending contest for corporate control, or to remove an asset that might attract an unfriendly bidder. This practice effectively penalizes well managed funds and strips a pension plan of important flexibility in the event of unsuspected impacts on plan assets.

To address this problem, the committee approved section 10(b) of the bill, which amends section 4044 of ERISA. Specifically, this action prohibits the distribution of any part of the residual assets of a pension plan to finance, directly or indirectly, any tender offer for the employer.

In keeping with its public policy orientation that pension plans be operated in the exclusive interest of beneficiaries, the committee established an exception for employees who are stockholders of the company as organized in an Employee Stock Ownership Plan. The bill permits surplus pension plan funds to be transferred to an Employee Stock Ownership Plan which employees could use to make a tender offer or competing bid, but only after a majority vote of approval has been cast by those who are plan participants of the employer.

The majority vote requirement by plan participants is intended to give those affected by the termination of the pension plan some influence over whether they wish to have their pension plan used to provide financing for parties involved in a tender offer. The funds shifted to an ESOP are residual assets. The residual assets are not transferred unless the pension plan is terminated. Whether or not this is in the best interests of the employees varies with the terms and conditions. Thus the merit of the termination of the pension plan and the shifting of funds to an ESOP can only be evaluated on a case-by-case basis. A majority vote is the best way to determine the intent of the plan participants.

At the committee's June 16, 1987 hearing, witnesses noted that the best interests of ESOP participants was not always foremost in the minds of those who may wish to use the ESOP to accomplish other goals with regard to the contest for control of the company in question. A majority vote requirement prior to the transfer of residual assets to an ESOP provides a needed degree of control over the use of an ESOP.

V. PROXY DISCLOSURE

Ten percent shareholders will receive increased access to the issuer's proxy statement.

Before tender offers became popular in the 1960's, the primary method of contesting corporate control was through the proxy process. Dissidents attempted to persuade a majority of shareholders to vote for certain provisions, or even for a new board that presumably would replace management.

Proxy contests provide several advantages over hostile tender offers. Aside from the cost of mounting the mailing, telephoning, and advertising in an effort to win votes, the bidder need not raise the enormous amount of funds necessary to purchase shares outright.

In order to remove some of the barriers to proxy contests, the committee, in section 11, directed the issuer to provide equal space, coverage and treatment in the company's proxy statement as is received by the issues and positions of the board of directors or management of a company to any shareholder owning not less than 10 percent of the issuer's security.

The bill improves the existing rights of large shareholders under SEC rule 14a–8 to have included in proxy materials sent to all shareholders, information and descriptions of shareholder issues and board candidates on the ballot. While SEC rules, supported by court decisions, permit shareholder issues to appear on the ballot, there is little ability for those shareholders to present justification for the initiative or board candidates. This provision adopted by the committee permits a more substantial description to be included with proxy materials. Because shareholders have little practical ability to identify other shareholders, the provision would also provide a means for shareholders to get information to other shareholders through the management's access to the proxy distribution system. As a result of these provisions shareholders will be able to evaluate and make more informed decisions on the matters before them.

VI. STUDIES

The committee also approved several studies.

A. To Analyze Potential Abuses of Leveraged Buyouts, the SEC Shall Study Such Transactions

Just as bids initiated by outsiders can be abusive to shareholders, leveraged buyouts engineered by incumbent management can also be abusive. The committee has witnessed numerous cases of companies that buy out their stock only to publicly re-issue stock within a short time. This raises the possibility that the company is pur-

chasing it's stock at an undervalued price, something that management is in a particularly advantaged position to ascertain.

Current regulations may be inadequate. The Commission currently regulates leveraged buyouts under Rule 13e-3, 17 CFR 240.13e-3, which requires detailed disclosure of the background of the transaction to express a view on whether the transaction is fair to unaffiliated shareholders. Management must also explain the basis for that relief. The rule, however, does not impose a substantive fairness requirement and does not call for the appointment of an independent appraiser to issue an opinion on the fairness of the consideration.

While investment banking firms are routinely hired in going private transactions to issue a fairness opinion, obvious conflicts of interest are present when they are hired by management and often are paid on a contingency basis. In addition, rule 13e-3 may not provide a basis to challenge the adequacy of the investment banking firm's examination of the company is reaching its opinion.

Section 16 of the bill requires the Commission to study leveraged buyouts and other going private transactions in which securities of an issuer are being purchased by corporate management.

The Commission's study will examine the conflicts of interests present in these transactions, whether adequate disclosure is provided to shareholders in such transactions and whether shareholders are being harmed. The study will specifically examine whether appropriate appraisals of the fairness of the offer are being made available to shareholders.

A report on the findings and results of the study on leveraged buyouts must be transmitted to Congress no later than 6 months following enactment of this legislation.

B. The SEC Shall Study the Proxy Process

Some observers have suggested that the proxy system can be improved by instituting a system of confidential voting to protect shareholders' privacy and to prevent coercion. Currently, corporate management is able to see how shareholders have voted, and there have been allegations that in some cases institutional investors and company employees have been subjected to pressure to cast their votes with management. A confidential voting system would require that only the proxy tabulator and the inspector of elections know the identity of shareholders voting by proxy. Management and other parties would be told only the total number of shares and percentages voted for and against each proposal; no one would be told who had voted for or against a proposal.

In addition to protecting privacy and preventing coercion, supporters of a system of confidential proxy voting argue that permitting management to review ballots gives management an unfair advantage over dissident shareholder. Management is able to target shareholders who have voted against them and contact these shareholders in an attempt to change their votes.

At the same time, some argue that proxy confidentiality is unnecessary. The relationship between shareholders and a corporation is voluntary, unlike the relationship between a government and its citizens. Thus, the analogy to political elections is faulty. Another argument against proxy confidentiality is that in a con-

tested election, both sides will want to challenge questionable ballots and therefore will need to see how large stockholders voted.

An alternative reform of the proxy process which has the same aim of promoting institutions to vote independently is to require them to disclose their voting policies and their votes on particular issues. Several former ERISA administrators have suggested that institutional investors would carry out their fiduciary duties better with fuller disclosure. Proxy confidentiality vs. greater disclosure is basically a debate between competing philosophies. Advocates of confidential voting argue that shielding decisions from outside review produces the best outcome. Advocates of disclosure argue that making the decisions of fiduciaries subject to scrutiny by their beneficiaries would produce the best results.

The SEC is to weigh these considerations in its evaluation of the proxy process. Specifically, section 16 requires the SEC to conduct a study of the proxy process and issue a report to Congress not later than 6 months after the date of enactment. the SEC is to hold public hearings and invite all interested parties to testify, including securities issuers, institutional investors, securities firms, and proxy solicitors. The specific issues that the SEC should address include whether proxy voting should be confidential; whether bidders in contests for corporate control should have access to the proxy machinery, at their own expense, on an equal basis with corporate management; and any other proposals to make corporate management more responsive to shareholders' concerns.

The committee does not intend to indicate any predisposition on any of these issues.

VII. INCREASED INSIDER TRADING PENALTIES, CHINESE WALL PROCEDURES, REGISTRATION AND REGULATION OF ARBITRAGEURS

The committee approved a number of changes designed to restrict the improper spread of insider information including: Increasing the penalties for insider trading; requiring the SEC to prescribe rules and regulations to prevent the misuse of material nonpublic information; and requiring the registration and regulation of tender offer arbitrageurs.

Efforts to curb insider trading are crucial to the capital formation process that depends on investor confidence in the fairness and integrity of our securities markets. The investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about the issuer of such securities. Improper insider trading threatens the securities markets by undermining the expectations of fairness and integrity that are the foundation of public confidence.

A. Increased Insider Trading Penalties

To discourage insider trading, criminal penalties are increased from a maximum of 5 years to 10 years in jail, fines are increased from a maximum of $100,000 to $1,000,000, and obstruction of justice or perjury in connection with an insider trading investigation is penalized by an automatic 1-year jail sentence.

With the increase in mergers, the committee has observed a parallel increase in the number of successful insider trading cases

brought by the Government. Before 1984, there were 12 criminal prosecutions for insider trading in the United States. Between 1984 up to the time of the *Dennis Levine* case, Government prosecutors successfully jailed or fined another 40 insider traders. Since the *Levine* case, there have been another 12.

U.S. District Attorney Rudolph Giuliani stressed the connection between the number of insider trading cases he has prosecuted and the surge in takeovers. SEC enforcement director Gary Lynch testified before the committee, "I definitely think there is a causal relationship."

Recent enforcement actions brought by the Government for insider trading violations relating to a takeover or change of control include some now familiar names: Ivan F. Boesky, Martin A. Siegel, Dennis B. Levine, Robert M. Wilkis, Ira B. Sokolow, David S. Brown, Ilan K. Reich, Randall D. Cecola, Michael M. David, Andrew D. Solomon, Robert Salsbury, Morton Shapiro and Daniel J. Silverman, to name a few. Others include Samuel Aksler, Melvin N. Pomerantz, Alfred E. Kopfmann II, Amie E. Mosher, James E. Flaherty, Jr., Thomas M. Hartnett, Anthony M. Franco, Harvey Katz, Martin M. Lewis, David J. Henderson, John S. Newton, Carlyle W. Higgins, Morgan F. Moore, and Manohar Lal Madan.

In other enforcement proceedings the SEC has brought actions involving insider trading against the investment banks Kidder Peabody and Co., Inc., and The First Boston Corp. Without admitting or denying the allegations involved in these separate and unrelated complaints both Kidder Peabody and First Boston disgorged significant illegal profits and paid large civil penalties.

To confront better the problem of rampant insider trading, enforcement officials have recommended stiffer penalties. For example, U.S. Attorney Giuliani recommended a "mandatory minimum additional penalty of 1 year to 2 years for those who are proven beyond a reasonable doubt to have been engaged in perjury or obstructing—an SEC—investigation."

In 1987, Securities and Exchange Commission Chairman John Shad testified before the Securities Subcommittee during oversight hearings on the SEC budget authorization that "I think the greatest inhibitor of insider trading is imprisonment."

In light of the recent insider trading scandals and apparent insufficient civil and criminal sanctions available under existing law, the committee agreed to increase the penalties.

The bill would amend section 32 of the Exchange Act to provide for criminal fines of up to $1,000,000 and imprisonment for up to 10 years for any willful insider trading. The bill would also provide for an additional 1 year sentence, to be served concurrently, for intentional obstruction of justice and perjury in connection with any investigation of any alleged insider trading.

The committee believes that increased penalties will increase deterrence. The current insider trading scandals and allegations of collusion in takeover bids, including "warehousing" and "parking" of securities, evidence the lack of respect for existing sanctions.

B. Chinese Wall Procedures

To improve the controls on inside information within a securities firm, the SEC is authorized to regulate Chinese Walls.

Many securities firms maintain several divisions. Some of these divisions enjoy access to confidential material information that could be wrongly used if disseminated to other divisions. To prevent this wrongful dissemination, firms have been encouraged to maintain Chinese walls and other appropriate procedures.

However, recent enforcement actions by the SEC raise questions as to whether existing procedures to control the flow and prevent the misuse of confidential information at multiservice brokerage firms are adequate. Concerns have also been expressed as to whether full and complete recordkeeping exists at the firms to demonstrate compliance with their Chinese walls procedures. For example, a recent SEC action against a multiservice broker-dealer alleged that a trader traded for the firm's proprietary account while in possession of confidential nonpublic information. In this instance, the firm had Chinese wall procedures in place, but failed to abide by their own guidelines and prohibitions and the firm was found to be in violation of securities regulations.

Other recent insider trading actions have raised the issue of the effectiveness of institutional procedures in limiting the misuse of information in firms that operate active merger and acquisition as well as tender offer arbitrage departments. In one case, a broker-dealer department head was alleged to have traded while in possession of material, nonpublic information on upcoming merger and acquisition transactions gleamed from his position inside the firm, although it appears that his receipt of the information was in conformity with that broker-dealer's Chinese wall procedures. In another action, information obtained from one person's position in the merger and acquisition department of one broker-dealer was alleged to have been used to effect trades in accounts at another broker-dealer.

In light of these developments, the committee believes it is appropriate for the Commission to take a more active regulatory role in the establishment and monitoring of Chinese wall procedures.

The committee recognizes that there are significant variations in the size of brokerage firms and the types of businesses in which they engage and that procedures can, and should, be tailored to meet those differences. However, the committee believes that the existence of procedures in this area should be a requirement and not just be available for use by a firm in a defensive posture. Similarly, the committee believes that adequate records of compliance with Chinese wall and watch list procedures should be mandated to ensure the auditability of the process.

Section 12 provides the Commission with rule-making authority to regulate broker-dealers' and associated persons' dissemination of material, nonpublic information as well as to prevent its misuse. The committee expects that the rules promulgated by the Commission should require broker-dealers to establish written procedures and systems to regulate and monitor dissemination of information within and outside the broker-dealer or its associated persons while in possession of such nonpublic information. In taking this regulatory action, the Commission should consider not only the proper physical separation between trading and other areas of the firm's business, but also the proper use of watch and restricted lists to ensure the efficiency of the firm's Chinese wall procedures.

Further, in order to assure that such procedures and systems are operating effectively, it will be necessary to review the procedures and examine their implementation by the broker-dealers. To accomplish this, Commission rules should require that records and reports relating to operation of the systems and compliance with these rules be made and kept and furnished for self-regulatory organization or Commission review. Since broker-dealers vary in size, type, and nature of business, the Commission's rulemaking should permit distinctions in the establishment and operation of Chinese wall systems to accommodate such differences.

C. Registration and Regulation of Arbitrageurs

The Tender Offer Disclosure and Fairness Act of 1987 amends the Exchange Act to define the term "tender offer arbitrageur" and to broaden the current definition of a "dealer" found in section 3(a)(5) of the Exchange Act to include specifically tender offer arbitrageurs, as defined in section 3(a)(47) of the Exchange Act. Since dealers in securities must register with the Commission pursuant to section 15(b), the legislation would require only registration of any tender offer arbitrageur that is not already registered.

The specific inclusion of tender offer arbitrageurs within the definition of a dealer is in response to the increasing presence of entities who regularly purchase or sell securities for their own accounts in response to or anticipation of tender offers. Such activities may constitute a significant portion of the trading in a target company's securities during a tender offer. As demonstrated by a number of widely publicized enforcement actions brought by the Commission, the economic power exercised by tender offer arbitrageurs creates an environment with the potential for manipulation, insider trading, and other abuses that are antithetical to the protection of investors and preservation of the integrity of the securities markets.

Recent reports suggest that limited partnerships are increasingly being formed to create a broad capital base with which to speculate in securities of issuers that are subject to tender offers [See Anders, "Arbitrage Partnerships Make a Comeback," Wall St. J., June 19, 1987, at 37, Col. 1; Dorfman, "Return of Hedge Funds: Money Managers with Fees Linked to Profits Gain Favor," Wall St. J., June 15, 1987, p. 29, Col. 4]. Many of these limited partnerships have less than 100 investors in order to avoid Federal regulation and oversight under the Investment Company Act of 1940. Moreover, other entities, which are not subject to regulation under the Federal securities laws, are also reported to be actively engaged in tender offer arbitrage. These entities may play a crucial role in the takeover process, amassing large amounts of the target company's stock for sale to the highest bidder. Yet, unlike registered broker-dealers, their activities may not be effectively monitored or regulated.

Because of the secretiveness of arbitrageurs who are not otherwise regulated, most accounts of their activities are based on estimates and speculations. However, it is clear arbitrageurs are a force in the market. Published reports indicate that arbitrageurs may be responsible for up to 90 percent of the trading activity in the two securities involved in an uncontested exchange offer and that over 50 percent of all tenders come through arbitrageurs. It

has also been contended that tender offer arbitrageurs overprice target company shares, tipping the balance in favor of the bidder. Thus, many tender offers may succeed for reasons only tangentially related to the merits of the offer itself. The general enabling character of the proposed amendments would give the Commission power to require the registration of tender offer arbitrageurs who are otherwise unregulated and broad public disclosure of their operations.

Although many tender offer arbitrageurs are registered as broker-dealers, the bill will further clarify and extend the application of the broker-dealer registration requirements to all tender offer arbitrageurs, and require them to comply with the regulatory scheme established for broker-dealers. Tender offer arbitrageurs will be subject to the same provisions of the Exchange Act regarding financial responsibility, books and records, financial reporting, and limits on association of statutorily disqualified persons, that are applicable to all broker-dealers. In addition, they will be required to become members of a self-regulatory organization and submit to regular inspections by those organizations, as well as the Commission, that are designed to monitor compliance with broker-dealer regulations and to detect potential problems.

In the context of tender offer activity, the definition of a tender offer arbitrageur is more broadly drafted than the dealer definition to include most persons whose presence in the market create the potential for the abuses addressed by this legislation. Thus, persons who regularly play a role in providing market liquidity during tender offers or who acquire significant positions in target companies' securities would fall within the definitions. As with the existing definition of a dealer, however, tender offer arbitrage need not be the primary business of the person, so long as it regularly pursues a conscious course of trading in the securities of issuers that are currently, or anticipated to be, the subject of tender offers, or involved in other extraordinary corporate events such as mergers.

In recognition of the broad coverage of the definition, certain persons that might otherwise fall within the language used to define a tender offer arbitrageur are specifically excluded. These persons include natural persons acting individually, registered broker dealers, registered investment companies as well as those subject to the exemption in section 3(c)(11) of the Investment Company Act of 1940, and employee benefit plans that are subject to the fiduciary regulations under section 401 of the Employee Retirement Income Security Act of 1974. The exclusion of natural persons is appropriate because, acting solely on their own behalf, they generally lack the financial resources necessary to play a significant role in tender offer arbitrage. In addition, registered brokers, dealers and investment companies and employee benefit plans are currently subject to a comprehensive system of Federal regulation that addresses many concerns of this amendment.

The definition, as previously mentioned, also contains explicit authority for the Commission to exempt persons by rule or order, either unconditionally, or upon specified terms and conditions. Because of the breadth of the definition, some entities may fall within the letter of the definition, even though their registration as broker-dealers would not further the goals of this legislation. The

exemptive and rulemaking authority provided in the definition should provide the Commission with sufficient flexibility to grant relief to entities where regulation is not warranted. Thus, for example, the Commission may determine that the extent of existing regulation of an entity, its low level of arbitrage activity, or the remoteness of its investment activity from the tender offer process reduce the concerns addressed by this legislation.

In sum, section 9 is intended to provide a mechanism for the Commission to require registration of tender offer arbitrageurs where it believes such registration is necessary or appropriate to fill a regulatory gap. In this regard, the Commission should consider exempting registered investment advisers and federally insured depository institutions. It may also be appropriate to exempt entities such as charitable, religious, or educational organizations except to the extent that such organizations may be used to evade the purposes and objectives of this provision. Further, the committee believes that, pursuant to the authority granted under section 9 of the bill, it may be appropriate for the Commission to develop "safe harbor" tests under this provision: (1) to define the extent of activity which would tend to establish that a person is "regularly" buying and selling in anticipation of a tender offer, and (2) since the committee does not intend that long-term, value-oriented, investors should in general be reached by this provision, guidelines on activity which might constitute trading "in anticipation" of a tender offer.

The committee believes that the Commission should promulgate regulations under this section to prevent unnecessary time and expense in seeking exemptive relief.

VIII. THE RESPECTIVE STATE AND FEDERAL ROLES IN REGULATING TENDER OFFERS

An important and sensitive issue considered by the committee, in its hearings and otherwise, was the respective roles of State and Federal laws in regulating contests for control of State-chartered corporations by means of a tender offer, an issue addressed by the Supreme Court in April 1987 in the case of *CTS Corp.* v. *Dynamics Corp. of America*, 107 S. Ct. 1637 (1987). Following the *CTS* decision, the committee was urged to approve legislation which would preempt State statutes having an impact on tender offers. The committee, however, rejected proposed amendments that would have accomplished that result. The bill as reported is not intended to alter in any way the role which States play in such corporate control contests or to affect the *CTS* decision in any respect.

A. The Traditional Role of the States

Corporate Governance

In the United States, the corporation is a creature of State law and has no legal existence absent the granting of a State charter. The Federal Government does not charter corporations with a few minor exceptions which primarily relate to certain financial institutions and quasigovernmental agencies. Accordingly, the vast majority of U.S. corporations receive only those powers which their individual State-granted charters give them. As the Supreme Court

stated in *Cort* v. *Ash*, 422 U.S. 66 (1975) and reiterated in *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977):

> "Corporations are creatures of State law and investors commit their funds to corporate directors on the understanding that, except where Federal law expressly requires certain responsibilities with respect to stockholders, State law will govern the internal affairs of the corporation."

Cort, 422 U.S. at 84.

Over the years an elaborate body of State law, both statutory and judge-made, has evolved regulating the rights and duties of stockholders, directors, and officers of State-chartered corporations. As the Supreme Court recently stated in its *CTS* decision:

> "It * * * is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."

107 S. Ct. at 1650.

It is State, not Federal, law that determines, for example, the rights of shareholders, "including * * * the voting rights of shareholders." *Id. See, e.g.*, Revised Model Business Corporation Act secs. 6.01, 7.21 and 7.25 [1984] [hereinafter cited as RMBCA]; Del. Gen. Corp. Law secs. 151(a) and 212(a). Similarly, state law determines which matters may be authorized by the board of directors acting alone and which must be authorized by the shareholders. State law typically requires, for example, that certain control transactions, such as mergers or sales of substantially all corporate assets, be approved in advance by the shareholders and establishes the vote required (often a "supermajority") for shareholder approval of such matters. *See, e.g.*, RMBCA secs. 11.03 and 12.02 [requiring a majority of the outstanding shares]; N.Y. Bus. Corp. Law sec. 903 [two-thirds of outstanding shares]. Comparably, certain State control share acquisition statutes, such as the Indiana Act upheld by the Supreme Court in *CTS*, require that a party accumulating a substantial stock interest in a corporation obtain the prior approval of existing shareholders before he can exercise voting rights that might affect control. State law likewise regulates the conduct of shareholder meetings, specifies who may call such meetings and prescribes whether, and the procedures by which, actions may be taken without a shareholder meeting. RMBCA sec. 7.01 *et seq*; Del. Gen Corp. Law secs. 211, 212, 228. Similarly, state law establishes what obligations controlling shareholders owe to minority shareholders. *See, e.g., Pearlman* v. *Feldman*, 219 F.2d 173 (2d Cir.) (applying Indiana law), *cert. denied*, 349 U.S. 952 (1955); *Jones* v. *H.F. Ahmanson & Co.*, 1 Cal. 3d 93 (1969).

The Supreme Court has consistently recognized that State law also governs the rights and duties of corporate directors:

> "As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law. 'Corporations are creatures of State law' and it is State law which is the font of corporate directors' powers.

Burks v. *Lasker*, 441 U.S. 471, 478 (1979) (citations omitted).

State law also defines the directors' powers over the corporation and establishing the vote required to elect directors, whether

shareholders have the right to cumulative voting in the election of directors, whether the corporation's directors may have staggered terms of office, and the power of the shareholders to remove directors prior to the expiration of their term of office. RMBCA secs. 7.28, 8.01, 8.06, and 8.08; Del. Gen. Corp. Law, secs. 141, 214.

These State laws have worked well, evolving to meet the changing needs of the times. From time to time in our history Congress has examined the question of whether to federalize the chartering of corporations, and each time has decided against the idea. Internal corporate affairs continue to be governed under the law of the State that charters the corporation.

Regulation of Securities

In addition to State corporate laws, which regulate the creation and governance of corporations, the States have also actively regulated the offer and sale of securities. Indeed, State regulation of securities transactions began as early as 1911 with the adoption of a so-called "blue sky" statute by Kansas. By the early 1930's, most states had passed such blue sky laws regulating offers and sales of securities within their borders.

In the aftermath of the Great Stock Market Crash of 1929 and the subsequent depression, there arose widespread agreement that remedial legislation was needed to provide additional regulation of securities transactions. The States, however, were effectively precluded from responding to the problem in light of the constitutional limitations imposed on them by the Commerce Clause and by a lack of coordination among the States. Congress therefore responded to the economic crises by adopting, among other legislation, the Securities Act of 1933. The core of this "truth in securities" law is a requirement that investors receive full and fair disclosure relating to the securities they purchase. Thus, the Securities Act requires issuers of securities to provide prospectuses to potential investors and prohibits issuers and underwriters from misstating any fact or omitting any "material" fact about the issuer and the offering.

Sections 16 and 18 of the Securities Act of 1933, however, made it clear that Congress had no intention of preempting the role of the State in this area. Section 18 stated, for example, that "nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person." In other words, Congress decided to regulate offerings of securities, but in doing so was not attempting to adopt a comprehensive Federal law of corporations.

The Federal securities statutes, insofar as they apply to public corporations, accordingly established an important, but limited, overlay on State law. As the Supreme Court has stated: "in this field congressional legislation is generally enacted against the backgound of existing State law; Congress has never indicated that the entire corpus of State corporation law is to be replaced" by Federal law. *Burks,* 441, U.S. at 478. Indeed, not only was State corporate law preserved, but Congress also specifically refused to preempt the States' blue sky laws. Public offerings today are sub-

ject to regulation by both the Federal Government and every State within which the securities are offered for sale.

The Securities Exchange Act of 1934 was intended to supplement the Securities Act by eliminating abuses that had come to light in the trading of already issued—as opposed to new—securities in the secondary markets. As with the Securities Act, a principal focus of the Exchange Act was on disclosure by issuers and the prevention of fraud. The 1934 Act also created the SEC to enforce both the 1933 and 1934 laws. And, again, Congress made explicit its intention not to preempt the role of the States. Section 28(a) in the 1934 Act states:

> "Nothing in this title shall affect the jurisdiction of the securities commission of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder."

It is thus clear that Congress had no intention of interfering with the States' traditional role in regulating corporate governance when it passed the Securities and Exchange Acts of 1933 and 1934.

B. Federal Regulation of Tender Offers (The Williams Act)

The Federal securities laws not only required disclosure in connection with the issuance and trading of securities, but also imposed disclosure and procedural regulations on certain forms of corporate control contests, particularly with regard to the solicitation of proxies. However, niether Federal nor State law prior to the 1960's regulated control contests conducted by means of a cash tender offer. Bidders thus were able to acquire control of public companies by making cash offers at a premium above the market, on a first-come, first-served basis. Because bidders were offering cash, and not securities, existing Federal securities disclosure requirements did not apply. In 1968, in response to the lack of information available to investors about a cash tender offer for their securities and certain abusive practices developed by bidders, Congress amended sections 13 and 14 of the Securities Exchange Act of 1934. These amendments are known as the Williams Act.

The Williams Act's primary purpose was to protect the shareholders of a target company in a tender offer through a policy of disclosure. The act was not intended to regulate the substance of tender offers, nor the response of companies to such offers. Rather, Congress simply intended to assure that stockholders had sufficient and timely information to make intelligent decisions on tender offers.

The Williams Act thus is essentially a disclosure statute, as the Supreme Court emphasized in 1985: "It is clear that Congress relied primarily on disclosure to implement the purpose of the Williams Act." *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985). The act therefore provides a framework within which offerors, and target managers responding to the offer, must provide material information to target shareholders.

As with the Federal securities laws generally, however, the Williams Act is not limited to pure disclosure. In addition to section 14(e)'s broad antifraud provision, sections 14(d) and (e) of the act and rules thereunder set forth certain discrete procedural require-

ments. The Supreme Court in examining these in the *CTS* case stated:

> "For example, stockholders who tender their shares may withdraw them during the first 15 business days of the tender offer and, if the offeror has not purchased their shares, any time after 60 days from the commencement of the offer. 15 USC sec. 78n(d)(5); 17 CFR secs. 240.14d-7(a)(1)(1986). The offer must remain open for at least 20 business days. 17 CFR sec. 240.14e-1(a)(1986). If more shares are tendered than the offeror sought to purchase, purchases must be made on a pro rata basis from each tendering shareholder. 15 USC sec. 78n(d)(16); 17 CFR sec. 240,14(8)(1986). Finally, the offeror must pay the same price for all purchases; if the offering price is increased before the end of the offer, those who have already tendered must receive the benefit of the increased price. sec. 78(n)(d)(7)."

CTS, 107 S. Ct. at 1644.

Certain of these rules, of course, are simply intended to make effective the act's disclosure requirements, since they "require or prohibit certain acts so that investors will possess additional time within which to take advantage of the disclosed information." *Schreiber*, 472 U.S. at 9.

C. The Constitutional Relationship of State and Federal Laws Affecting Control Contests

Despite the fact that Virginia had already passed legislation regulating tender offers prior to the passage of the Williams Act, nothing in the act's legislative history suggests that Congress intended to preempt the States from regulating tender offers or, more generally, other forms of corporate control contests. Rather, its provisions are carefully limited to disclosure and the manner in which the bid is conducted. Nor did Congress, in adopting a policy of neutrality with respect to bidders and targets, intend the act to create a federally protected right for bidders to succeed with every offer or free from State regulation in connection with tender offers: "tender offerors were not the intended beneficiaries of the bill." *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 28 (1977). Moreover, the act did not affect State laws governing the fiduciary duties and powers of incumbent managers with respect to control contests. *See Moran* v. *Household International, Inc.*, 500 A.2d 1346, 1353 (De. 1985); *cf. CTS*, 107 S.Ct. at 1647 n.9. Likewise, the act was not intended to displace State law governing the procedures to be followed and rights of shareholders, bidders or targets after the tender offer is over. In passing the act, Congress thus did not amend section 28(a) of the Exchange Act, which expressly preserved State law from preemption. Rather, the Williams Act was intended to fulfill the same goal as the other parts of the general Federal regulatory scheme. That is, to protect investors by requiring disclosure from control contestants and to provide certain procedural safeguards governing the conduct of the bid, with particular emphasis on assuring that investors will be able to receive, and digest and act on, the required information.

During the decade following the adoption of the Williams Act, many States adopted statutes to supplement the Federal tender offer rules protecting shareholders. By 1981, 37 States had adopted

legislation regulating tender offers. Despite the long-standing State role in regulating numerous aspects of control contests and the absence of preemptive language in the text and legislative history of the William Act, various of the State tender offer laws were challenged on constitutional grounds as burdening interstate commerce—and therefore violating the Commerce Clause of the Constitution—or as interfering with the Federal regulatory scheme under the Williams Act—and therefore violating the Supremacy Clause of the Constitution.

Edgar v. *MITE*

In 1982, the Supreme Court first addressed the constitutionality of State tender offer regulation in the case of *Edgar* v. *MITE Corp.*, 457 U.S. 624 (1982). That case involved a tender offer by the MITE Co., a Delaware corporation, for all the outstanding shares of the Chicago Rivet and Machine Co., an Illinois corporation. The Illinois Business Takeover Act regulated various aspects, including the substantive fairness of tender offers. For example, it allowed the Illinois Secretary of State to deny registration to a tender offer if he determined that the bid was unfair. The Illinois Act also covered all corporations in which Illinois shareholders owned 10 percent of any class of equity securities even if the corporations were not incorporated in Illinois.

The Supreme Court was sharply divided in *MITE*. A narrow majority of the Court—Justice White, who wrote the Court's opinion, joined in this respect by Chief Justice Burger and Justices O'Connor, Powell, and Stevens—held the Illinois Act unconstitutional because it directly regulated tender offers in such a way that a nationwide bid for a non-Illinois corporation having only minimal contact with Illinois could be blocked from going forward throughout the country. The Court noted, for example, that "* * * even when a State statute regulates interstate commerce indirectly, the burden imposed on that commerce must not be excessive in relation to the local interests served by the statute." *Id.* at 643. In regard to that point the Court also noted that "Illinois has no interest in regulating the internal affairs of foreign corporation." *Id.* at 646.

A plurality of three Justices—White, Burger, and Blackmun—would also have held the Illinois Act preempted by the Williams Act because it stood as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress. Because the Illinois Act introduced extended delay into the tender offer process and permitted a State regulator to review the substance of the bid, the plurality believed that it tipped the "balance" toward management and therefore frustrated Congress' intent in passing the Williams Act.

On its face, *MITE* did not bar the States from a role in the regulation of tender offers or related matters. Indeed, even the plurality implied that State laws regulating corporate internal affairs or governance adopted by the State of incorporation could pass constitutional muster. *See id.* at 645–46. After *MITE*, a number of States adopted new control contest statutes, which unlike the earlier statutes, applied only to corporations incorporated within the adopting

State or having significant contacts with the State.[1] They also generally did not directly regulate tender offers, but instead addressed matters of corporate governance and internal affairs traditionally subject to State law. Some such statutes also regulated the treatment of minority shareholders by the majority shareholders in mergers and similar control transactions. Between 1982 and April 1987, many of these statutes were challenged and almost uniformly were struck down by the lower courts as unconstitutional. *See, e.g., Dynamics Corp.* v. *CTS Corp.,* 94 F.2d 250, 260–63 (7th Cir. 1986), *rev'd,* 107 S. Ct. 1637 (1987); *L.P. Acquisition Co.* v. *Tyson* [1985–86] Fed. Sec. L. Rep. (CCH) para. 92, 271 (6th Cir. 1985).

CTS Corp. v. *Dynamics Corp.*

Typical among the so-called "second generation" of State statutes affecting corporate control contests is the Indiana "control share acquisition" statute. Under that statute a bidder, who seeks to acquire shares in a corporation that would give him more than 20, 33⅓, or 50 percent of the voting power, is required to deliver an "acquiring person statement" to the corporation for distribution to shareholders. A meeting of shareholders is then called within 50 days for the "disinterested" shareholders—*i.e.,* those shareholders other than the bidder or managers—to vote on the proposed acquisition. The shares acquired, or to be acquired, by the bidder are accorded full voting rights only if the transaction is approved by the shareholders at such meeting. The practical effect of this requirement is to condition acqusition of control of a corporation on approval by a majority of the pre-existing "disinterested" shareholders.

The Indiana statute was challenged by Dynamics Corp. after it made a tender offer for shares that would have given it a 27.5 percent stake in the CTS Corp., an Indiana corporation. On April 21, 1987, the Supreme Court reversed the judgment of the Seventh Circuit Court of Appeals and upheld the Indiana Statute. *CTS Corp.* v. *Dynamics Corp.,* 107 S. Ct. 1637 (1987).

The Court first held that the Williams Act did not preempt the Indiana statute. While the Indiana Act might delay the consummation of tender offers, any such delay was not in the court's view so severe as to contravene the policies of the Williams Act. The Court recognized that the Williams Act was intended to close a loophole in the earlier Federal securities regulation scheme by providing investors with sufficient information and time in which to make their investment decisions. *See CTS,* 107 S. Ct. at 1644. The Court therefore upheld the Indiana Act, finding that it "furthers a basic purpose of the Williams Act, 'plac[ing] investors on an equal footing with the takeover bidder' " by according shareholders additional rights in connection with proposed changes of control. *CTS,* 107 S. Ct. at 1645–46, *quoting Piper,* 430 U.S. at 30.

The Court also held that the fact that the Indiana statute might inhibit the exercise of voting power and other rights by a successful tender offeror after the consummation of the offer was not

[1] A summary of these statutes is set forth in Table 1 at the end of this section.

grounds for concluding that the Indiana statute frustrated the purposes of the Williams Act:

> "[W]e note that the Williams Act would preempt a variety of State corporate laws of hitherto unquestioned validity if it were construed to preempt any State statute that may limit or delay the free exercise of power after a successful tender offer * * *.
>
> "The longstanding prevalence of state regulation in this area suggests that, if Congress had intended to preempt all State laws that delay the acquisition of voting control following a tender offer, it would have said so explicitly."

Id. at 1647–48.

The Court also concluded that the Indiana Act did not violate the Commerce Clause of the Constitution. First, the Court noted that the act did not discriminate against interstate commerce or subject interstate securities transactions to inconsistent regulations, noting with respect to the latter issue that:

> "So long as each State regulates voting rights only in the corporations it has created, each corporation will be subject to the law of only one State. No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders."

Id. at 1649.

The Court then fund that Indiana had legitimate, well-established interests that were furthered by the act and that the act did not impose burdens on interstate commerce which outweighed the State's interests in regulating the governance of its corporations:

> "We think the Court of Appeals failed to appreciate the significance for Commerce Clause analysis of the fact that state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of State law. * * * A State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs. There can be no doubt that the [Indiana] act reflects these concerns. The primary purpose of the act is to protect the shareholders of Indiana corporations."

Id. at 1649–51.

The Court took note of arguments made by the *Dynamic Corporation* that in the *MITE* case the Supreme Court struck down an Illinois law regulating tender offers. In distinguishing the Indiana and Illinois statutes, the Court noted that the Illinois statute applied to both out-of-state corporations as well as in-state-corporations. The Indiana statute, by contrast, applied only to corporations chartered by that State. *Id.* at 1651.

D. Committee Rejection of Proposals That Might Affect the CTS Decision

The Supreme Court's decision in the *CTS* case reversed a trend of lower court decisions that had invalidated a variety of State statutes regulating corporate governance because those statutes might have an impact on tender offers. It recognized that State govern-

ments have a legitimate role to play in corporate control contests insofar as they regulate the internal affairs of corporations they charter. Nevertheless, after the *CTS* decision was handed down, various proponents of the economic efficacy of takeovers advocated that the Congress preempt State laws having any impact on takeover contests. These persons argued that such State laws increased the price which bidding firms had to pay for targets and thereby deterred otherwise profitable acquisitions, thus denying shareholders the premiums which they would otherwise receive.

Proponents of preemption also argued that allowing the States to play a role in regulating corporate control contests was causing a "Balkanization" of the securities markets. Several States, they contended, would be involved in regulating a single takeover. These advocates also argued that the *CTS* decision would harm shareholders as corporations would move their State of incorporation to States with the most protective tender offer laws in order to protect "entrenched" managers.

The National Association of Attorneys General, the National Governors' Association, and many other witnesses, on the other hand, urged the committee to resist such arguments. They argued that sound public tender offer policy required Congress to consider matters other than short-term profits for a few shareholders. For example, Mr. Anthony J. Celebresse, Jr., the Attorney General of the State of Ohio, in his June 23, 1987, appearance before the committee noted that:

> "States have not only the right but also the governmental duty to ensure that their corporate citizens are treated fairly and that they behave fairly. A fever-pitched tender offer which robs a community of jobs for no reason but to satisfy some raider's notion of developing an 'efficient' marketplace does a tremendous disservice to the employee, to the company, to the community, to the States and even to our national economy."

Those witnesses who supported the States' role in control contests also pointed out the absence of merit in the "Balkanization" argument. Under the *CTS* decision, tender offerors need only concern themselves with the Williams Act and the law of the State chartering the particular target corporation. It was also pointed out that management could only recharter a corporation in a different State if it has the prior approval of the shareholders with full disclosure to them as to the rationale for such a proposal. Thus shareholders, under the *CTS* decision, would be able to make an informed, independent decision as to whether reincorporation in a State having takeover laws was in their own best interest.

The primary Senate sponsors of S. 1323, as originally introduced, were convinced that short-term shareholder profits were not the only issue to be considered in regulating takeovers. That original bill included a provision specifically stating that the Williams Act should not be construed to supersede any law enacted by any State regulating the internal affairs or governance or contests for control of any corporation organized under the laws of that State. After hearings on the bill, that provision was dropped when it became clear that it was not needed in light of the Supreme Court's decision in the *CTS* case. As noted above, the bill reported by the committee is not intended to alter in any way the role States play in

corporate governance and corporate control contests under the *CTS* decision.

It should also be noted that the deletion of this provision does not reflect any change in the committee's belief that nothing contained in the Williams Act or the rules and regulations thereunder invalidates, impairs or supersedes current state insurance holding company laws—including notice, hearing and precommencement approval provisions—which provide, for the protection of policy holders, a comprehensive scheme of state regulation over the acquisition of control of the insurance companies. These laws are protected from Federal preemption by the McCarran-Ferguson Act.

"One Share/One Vote Proposals"

Some members of the committee argued that the bill should impose a requirement on virtually all publicly held companies that every share of voting securities must have the same vote and offered an amendment that would have mandated that result. Opponents of the proposal argued that it was in effect a preemption amendment and would invalidate Indiana-type control share acquisition statutes despite the Supreme Court's decision in the *CTS* case. Moreover, such an amendment would intrude upon the States' right to regulate the corporate affairs, including the per share voting rights, of corporations they charter.

During the consideration of the "one share/one vote" proposal, concerns were also expressed that, even aside from the preemption issue, the full implications of such a Federal intrusion into state corporate goverance were not altogether clear. The capital structure of public companies is governed today by state law and stock exchange listing requirements. In order for a company to issue classes of securities having different voting rights, the shareholders must vote to authorize such a change in the capital structure of the company. Countless reasons exist for a particular company to choose, with the authorization of its shareholders, to allocate voting rights among security holders in a manner other than one vote for each share. For example one member of the committee noted the recent acquisition of Texas Commerce Bancshares of Houston, Texas by Chemical Bank, of New York City. The voting rights of the securities offered to the Texas Commerce Bancshares shareholders were, along with other features of that security, designed in an innovative manner to permit the acquisition without having an adverse impact on the voting rights of preexisting shareholders of Chemical Bank.

Mr. David Ruder, the Chairman of the SEC, in his September 17, 1987, apprearance before the House Energy and Commerce Committee testified about a provision in H.R. 2172 that would sharply limit the issuance of shares with disparate voting rights. It was pointed out that such a proposal would interfere with innovative financing techniques, and Mr. Ruder recommended deferring action on it until the SEC had a chance to fully consider this question. Influenced by such concerns, the committee rejected the "one share/one vote" amendment. Instead, it ordered the SEC to study the impact of such a proposal. Thus, section 17 of the committee's bill directs the SEC to review any and all rules, policies, and practices of the national securities exchanges, and national securities

associations relating to shareholder voting rights. Not later than October 1, 1988, the SEC is to report to Congress the results of its review, including the effects such rules have on investors and the maintenance of fair corporate suffrage.

Defensive Tactics

The committee decided not to adopt restrictions on certain defensive actions, such as the so-called "poison pills" or "golden parachutes," used by corporations to defend against hostile takeovers. The committee noted, as discussed below, that the courts have been increasingly vigilant in ensuring that corporate actions in this area are proper, by reviewing the adoption of such devices under the "business judgment rule" developed by the courts.

State corporate law has long recognized "the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders." *Unocal Corp.* v. *Mesa Petroleum,* 493 A.2d 946, 955 (Del. 1985). In certain cases where a breach of this duty by a director or officer is alleged, the business judgment rule merely provides a presumption, which may be rebutted by plaintiff, "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.* at 954.

Under the business judgment rule, the courts now require directors who adopt a takeover defense to "show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," a burden which requires proof of "good faith and reasonable investigation," among other things. *Id.* at 955. They must also prove that the defense was "reasonable in relation to the threat posed." *Id.* The defense must be authorized by law and must not be undertaken "solely or primarily out of a desire to perpetuate—the directors or officers—in office." *Id.* Moreover, this analysis will be applied to a challenged takeover defense not only when it is adopted, but also when it is utilized by the target in connection with a particular tender offer. *See Moran* v. *Household International, Inc.,* 500 A.2d 1346, 1357 (De. 1985).

The "business judgment rule" reflects a judicial recognition that "officers and directors are the agents and fiduciaries of the shareholders and owe a duty of complete loyalty which is inconsistent with erecting insuperable barriers to hostile takeovers." *Dynamics Corp.* v. *CTS Corp.,* 794 F.2d 250, 254 (7th Cir. 1986), *rev'd on other grounds,* 107 S. Ct. 1637 (1987). In applying this rule, the courts have accordingly struck down a number of takeover defenses erected by target managers. Indeed, the committee found that the courts have been requiring corporate management to *show* their actions are fair and reasonable in defending against takeovers. See, *e.g., Unocal Corp.* v. *Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985); *Moran* v. *Household International Inc.,* 500 A.2d 1346 (De. 1985); *Revlon Inc.* v. *MacAndrews and Forbes Holdings, Inc.,* 506 A.2d 173 (Del. 1986); *Buckhorn, Inc.,* v. *Ropak Corp.,* 656 F. Supp. 209 (S.D. Ohio 1987); *Hansen Trust PLC* v. *ML SCM Acquisition, Inc.,* 781 F.2d. 264 (2d Cir. 1986); among others.

As the courts have recognized, particular defensive tactics or devices are not themselves necessarily abusive—it depends on how

and why they are utilized. Such tactics and devices can be used to further the best interests of shareholders, for example, by causing the bidder to raise his bid. As Judge Richard Posner recently stated, shareholders "want management to create a process that will maximize the value of their shares in a takeover situation. That may require the use of some defensive tactics." *Dynamics Corp.* v. *CTS Corp.*, 794 F.2d 250, 254 (7th Cir. 1986). See also *Enterra Corp.* v. *SGS Associates*, 600 F. Supp. 678, 686 (E.D. Pa. 1985); *Revlon* v. *MacAndrew & Forbes Holdings, supra*, 506 A.2d at 181. In light of the effectiveness of state law in this area, the committee determined that Federal regulation of takeover defenses was unnecessary at this time and would constitute an unwarranted intrusion into corporate governance matters appropriately subject to State regulation.

E. CONCLUSION

Even after the *CTS* decision, not every State statute dealing with corporate governance that impacts on takeovers will be immune to court challenges. The Supreme Court, as the *MITE* case shows, is prepared to strike down State statutes that have an unnecessarily broad impact on interstate commerce. As noted, the Committee believes that congressional action in this area is presently unwarranted: The State and Federal courts should be permitted to work out the parameters of the *CTS* decision on a case-by-case basis.

The committee did decide, however, that the appropriate role of state law in tender offer contests is an important issue which deserves further careful study, particularly in light of Federal Government actions that may have an impact on the States' ability to oversee matters of corporate governance. Section 15 of the committee bill therefore requires the Comptroller General of the United States, in consultation with the Securities and Exchange Commission and the North American Securities Administrators Association, to conduct a study of State laws which regulate tender offers and other changes of corporate control.

The study shall examine, but not be limited to: (1) the effect such laws have on the number of takeovers attempted and completed; (2) the rights and economic well-being of shareholders of companies subject to such laws; and (3) the impact such laws have on employment and communities. In conducting this study, the Comptroller General shall examine State laws adopted after January 1, 1982, and before January 1, 1989, and shall submit a report on the study to the Congress not later than October 1, 1989. The committee in calling for this study decided that if the Congress in the future wished to re-examine the pre-emption issue, the study would be a useful source of information for members to have in dealing with such an important and far reaching matter.

TABLE 1

SECOND GENERATION STATE TAKEOVER LAWS

1. Control Share Acquisition Statutes

An acquiror of more than a specified percentage of the issuer's stock must obtain shareholder approval of the acquisition in order to be accorded full voting rights or to complete the acquisition.

Ohio	Missouri	Louisiana
Oregon	Indiana	North Carolina
Florida	Hawaii	Massachusetts
Wisconsin	Arizona	Nevada
Minnesota	Oklahoma	Utah

2. Fair Price Statutes

Business combinations, as defined by the particular statute, between a large shareholder and the issuer must be approved by a specified shareholder vote unless the terms of the transaction meet certain minimum price and other conditions.

Connecticut	Georgia	Illinois
Kentucky	Louisiana	Maryland
Michigan	Mississippi	Virginia
Washington	Wisconsin	Florida
Pennsylvania	North Carolina	

3. Cash-Out Statutes

Upon acquiring a specified threshold percentage of the issuer's shares, a large shareholder or group must give notice of the acquisition to all shareholders and offer to buy their shares at a statutorily determined fair price.

Pennsylvania	Maine

4. Business Combination Statutes

Prohibit certain business combinations (such as a merger), as defined by the statute, between the issuer and a large shareholder for a specified period of time after the shareholder first acquires a large block of stock. After the time period expires, a business combination is still prohibited unless approved by a specified shareholder vote or the bidder pays a statutorily determined fair price to all shareholders.

Indiana	New Jersey	Minnesota
Kentucky	New York	Washington
Missouri	Arizona	Wisconsin

SECTION-BY-SECTION DISCUSSION OF THE BILL

Section 1. Short Title

Section 1 provides that the legislation may be cited as the "Tender Offer Disclosure and Fairness Act of 1987."

Section 2. Findings and Purposes

Section 2 sets forth Congress' findings that investors have not always received timely, adequate or sufficient information with respect to accumulations of securities in the market and the conduct involved in tender offers; that investors have at times been denied

fair treatment in the course of tender offers; that the integrity of the nation's securities markets and public confidence in them have been threatened by the conduct of parties in tender offers; that certain persons have sought to precipitate, intensify, and prolong excessive speculation in connection with acquisitions or proposed acquisitions of issuers of securities to the detriment of issurers, shareholders and the public; and that existing enforcement remedies have not been adequate to deter violations of the federal laws requiring disclosure of significant accumulations of securities and plans to acquire or seek control of publicly held corporations. Reaffirming the fundamental objectives and structure of existing law, including the mandate of the Securities and Exchange Commission to protect all investors, the section further states that the purposes of the legislation are to reduce the opportunities for abuse under the federal securities laws and to expand the protective mechanisms of such laws.

Section 3. 10-Day Window; Contents of Report

Section 3 makes certain amendments to the beneficial ownership reporting requirements of Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act") with respect to the timing, manner and contents of disclosure. Under current law, any person who acquires beneficial ownership of more than five percent of a class or most publicly traded equity securities must file with the Commission, and send to the issuer of the security and to each exchange where the security is traded, a statement containing specified information within ten calendar days after the acquisition. During this ten-day period, the acquiring person may purchase additional shares prior to making any disclosure.

The bill reduces the current ten-day filing "window" to five calendar days, and adds a new requirement that, within the same five days, the acquiring person make and file a public announcement containing the information specified in Section 5 of the bill. The bill also prohibits any person who crosses the five percent threshold from acquiring beneficial ownership of any additional securities of the same class until after the required statement has been filed with the Commission and the required public announcement has been made and filed.

Together these amendments ensure that information concerning stock acquisitions is made available to the market on a more timely basis, protecting shareholders who may otherwise sell their stock without knowledge of a possible control contest. The five-day filing requirement affords persons who acquire securities ample time to comply with the filing requirements and does not, moreover, unduly interfere with the activities of persons engaged in lawful programs to acquire the issuer. Such person could resume their acquisition of the issuer's stock as soon as they file the requisite statement and make the requisite public announcement.

In addition, the bill expands in several respects the information to be included in statements filed with the Commission pursuant to Section 13(d). The bill would add a new provision requiring disclosure of certain communications by the filing person within the thirty-day period preceding the acquisition regarding his intention to acquire the securities that are the subject of the disclosure state-

ment. If the filing person had such communications with any other person who has filed a statement under Section 13(d) or 13(g) with respect to equity securities of the same class, or with any other person (other than a broker or dealer acting in the ordinary course of business) who, to the knowledge of the filing person, in connection with such communications, acquired or agreed to acquire any such securities, disclosure of the identity of the other person, the fact of the communication, and the date of the communication would be required. The exception is intended to exclude normal communications by a broker or dealer, such as communications by retail brokers with their clients and by analysts with the investing public which do not relate directly or indirectly to influencing or effecting a takeover or change in corporate control. Disclosure of the content of the communications would not be required. This provision enhances detection of undisclosed collusion concerning takeovers. The category of communications governed by this provision and the requisite disclosure have been limited to minimize the recordkeeping burden on persons who accumulate a substantial amount of securities.

The bill also provides that the Section 13(d) statement to be filed must designate the purpose of the purchases, including whether the filing person's purpose is (a) for acquiring or influencing control of the issuer or (b) solely for passive investment purposes, without any purpose or effect of changing or influencing control, other than by voting the securities in matters coming before the securityholders in the ordinary course of business. Many filers simply state that the subject securities have been acquired for "investment" (but not always "passive investment") and describe a variety of investment purposes ranging from simply holding the securities for an indefinite term to cashing in on the investment by mounting a proxy fight and threatening to liquidate the company if successful. Accordingly, there is ample disclosure about an acquiror's options, but little about probability, and management and shareholders are left to their own ends in determining their investment. The bill therefore prohibits ambiguous and evasive disclosures of intent by filing parties. It is contemplated that the Commission will implement this requirement by providing appropriately labeled boxes on the Schedule 13D reporting forms, which would require the filing person to indicate the purpose of the acquisition by checking the appropriate box. This prophylactic provision also helps make effective the new requirements in Section 5 of the bill precluding tender offers by persons who claim an investment purpose until after corrective disclosure and a waiting period. A purpose of acquiring or influencing control would include the participation in or facilitation of any transaction having such purpose or effect, or having the effect of permitting any other person to acquire or influence such control. Under current law, acquirors not infrequently put a company into play by ambiguously disclosing their intentions and continue to purchase target company shares at low prices before disclosing their true intentions. This provision requires a clear statement of intent, eliminating the opportunity to take advantage of shareholders through calculated ambiguity.

The bill expands the types of information that must be included in the statements about the source of funds used to acquire the

subject securities. The required disclosure includes a summary of each agreement or arrangement relating to the extension of credit, the issuance of securities for cash, or any other acquisition of such funds, including the identity of the parties, the term, the collateral, the stated and effective interest rates, all fees to be paid in connection with the agreement or arrangement to any persons providing or arranging for the provision of such funds or other consideration, and all other material terms or conditions relative to any loan agreement or arrangement. The information also would include any plans or arrangements to finance or repay any amounts of such funds representing indebtedness incurred or to be incurred, or if no such plans or arrangements have been made, a statement to that effect.

The bill requires that the statement filed with the Commission contain a reasonably itemized description of all expenses incurred or estimated to be incurred in connection with the acquisition of the filing person's beneficial ownership, including filing fees, legal, accounting, financial advisory, investment banking fees, and similar fees and expenses. The statement would have to indicate whether the filing person has paid or will be responsible for paying any or all of the expenses. The bill amends Section 14(d)(4) of the Exchange Act to require comparable disclosure by companies whose securities are the subject of a tender offer.

Section 4. Time for Filing Amendments

Under current law, a disclosure statement filed pursuant to Section 13(d) of the Exchange Act must be amended "promptly" after any material change occurs in the facts set forth in the statement. Under current Commission rules, the acquisition or disposition of beneficial ownership of 1 percent or more of the outstanding shares of the class is deemed material. Whether an amendment is "promptly" filed depends on the particular facts and circumstances since there is no fixed rule. Section 4 of the bill requires that an amendment be filed, and a public announcement of the change be made and filed, no later than the close of business on the next trading day after the change occurs.

Section 5. Group Activity, Enforcement Measures, and Content of Public Announcement

Section 5 of the bill makes further amendments to Section 13(d) of the Exchange Act. Under current law, when two or more persons act as a group for the purpose of acquiring, holding, voting or disposing of securities of an issuer, the group is deemed to be a "person" for purposes of Section 13(d) and thus subject to its requirements. The bill amends the statutory provision relating to groups to make more explicit the intention that the group concept be applied broadly and flexibly, as reflected under existing case law and administrative practice. The amendments expressly provide that the statutory requirements apply to persons who act together pursuant to an express or implied agreement or understanding, and includes persons acting as a group, whether or not formally organized. In addition, the bill would make clear that the group concept applies to persons acting pursuant to an arrangement or understanding to indemnify against loss or to hold harmless. These

amendments are intended to reaffirm Congress' intent that the Commission and the courts broadly define the group concept so as to reduce the opportunities for circumventing the Exchange Act's disclosure and other requirements by structuring transactions involving substantial accumulations of securities in an unconventional manner. Parallel amendments would be made to Sections 13(g) and 14(d) of the Exchange Act in Sections 5 and 7 of the bill. Identical language regarding the definition of a group would also be included in new Section 4044(e)(1) of the Employee Retirement Income Security Act of 1974, as added in Section 10 of the bill.

Section 5 of the bill also prohibits any person who has disclosed in any statement filed under Section 13(d) of the Exchange Act that the acquisition is for investment purpose from acquiring, by tender offer or request or invitation for tenders, additional shares of the same class until 60 days after the date an amendment to the statement disclosing a control purpose is filed. The prohibition does not apply when the SEC exempts a transaction in light of a material change of circumstances which has resulted in the change of purpose for which the securities are held or were acquired. Currently, acquirors frequently fail to disclose their true control intentions or state their intentions so ambiguously as to mislead shareholders. The bill adds a needed deterrent against the filing of such untruthful or misleading statements of intention, so that shareholders are appraised of the person's true intentions at the time of filing. It is expected that the exception for material changes in circumstances will be available only in rare cases where a truly significant change of objective facts not under control of the offeror can be demonstrated. Nevertheless, the exception permits an acquisition to go forward in those few cases where there has been a true change in plans and the deterrent effect of the provision is therefore unnecessary.

Section 5 of the bill expressly prohibits fraudulent, deceptive or manipulative conduct in connection with any statement required to be filed under Section 13(d) of the Exchange Act, and authorizes the Commission to define and prescribe means reasonably designed to prevent such conduct. Other provisions of federal securities law applicable to such conduct would continue to apply.

The bill also specifies the minimum information that must be included in public announcements that would be required in Sections 13(d) (1) and (2) of the Exchange Act. The bill authorizes the Commission to prescribe by rule or regulation the means of dissemination and any additional information to be included in the announcements.

Section 6. Civil Liability

Section 6 of the bill amends Section 21(d) of the Exchange Act. Under current law, the Commission's principal remedies for violations of the disclosure or filing requirements of Sections 13, 14 and 16(a) of the Exchange Act are to seek an injunction and appropriate ancillary relief, or, in the case of Sections 13 and 14, to institute administrative proceedings. Section 6 of the bill increases the Commission's alternatives in this area, by authorizing the Commission to seek civil penalties for violations, or for the aiding and abetting of violations, of Section 13 (d), (f), and (g), Section 14 and Section

16(a), or the rules and regulations thereunder. The amount of the penalty would depend on the facts and circumstances, but could not exceed three percent per day of the value of the securities that are the subject of the violation, for each day that the violation continues. In no event could the cumulative penalty exceed 50 percent of the aggregate value of the securities. The value of the securities for purposes of the penalty would be measured by their highest market value during the period of the violation, and would include all securities required to be reported. No action may be brought more than 3 years after the date of the violation.

In addition, the bill expressly authorizes the court to impose, in the context of a penalty action, any appropriate equitable relief, just as it could in an injunctive action brought by the Commission or by a private party. Section 6 also adds a provision to Section 21(d) expressly codifying that the courts in civil injunctive actions for violations of Sections 7, 13(d), 13(f), and 13(g) of the Exchange Act, or rules thereunder, may grant appropriate equitable relief, including an injunction against voting shares, an order compelling divestiture, and an injunction against making any tender offer or effort to acquire or influence control for a specific period. Such relief would be in addition to any other relief that may already be available under the Exchange Act. This provision would emphasize the intention that the courts assure that all equitable relief appropriate to fully accomplish the remedial purposes of the specified statutory sections be imposed.

Section 7. Tender Offers.

Section 7 of the bill adds two new provisions to Section 14(d) of the Exchange Act. Pursuant to Commission rule, tender offers must remain open for twenty business days. The bill extends this period for tender offers subject to Section 14(d) by requiring any person who makes a tender offer to hold the offer open for a minimum of thirty-five business days. As under current law, no limitation on the maximum period an offer may remain open would be prescribed. The provision does not alter existing requirements providing for the extension of the offering period with respect to a particular tender offer if there is material change in disclosure or in the terms of the offer and shareholders have not had adequate time to evaluate the new information.

The bill provides for a longer minimum offering period in one circumstance. If, during the thirty-five business day period, a qualified employee stock ownership plan, within the meaning of the section, notifies the offeror, the issuer, or the Commission, of its intent to acquire additional securities of the issuer on terms substantially equivalent to other offers, the thirty-five business day period would be extended to ninety-five business days. Thus, if during the pendency of a third party tender offer, a qualified plan commences a substantially equivalent competing tender offer, the minimum offering period for both tender offers would be ninety-five business days.

In addition, the bill requires, in certain circumstances, that acquisitions be effected by tender offer, and thus subject to the requirements of Section 14(d) and other applicable regulations. The bill prohibits any person, including a group, from purchasing or

agreeing to purchase shares of any class of most publicly traded equity securities if the purchaser is, or after the purchase would become, the beneficial owner of more than twenty-five percent of the class, unless the acquisition is made pursuant to a tender offer or a request or invitation for tenders. This provision is intended to address certain open market purchase programs. The twenty-five percent threshold, necessarily, is an arbitrary figure and is not intended to affect existing federal or state laws or regulations defining "control" of a corporation. The prohibition does not apply to an acquisition of up to two percent of the class during a twelve-month period; an acquisition of a block of at least ten percent of the outstanding shares, if held by the seller for at least two years; an intra-family acquisition; or an acquisition by a person owning more than 50 percent of the outstanding shares before the purchase. The Commission would have the authority to exempt additional transactions by rule or order. For example, institutional investors, investing in the ordinary course of business, and not for the purpose of acquiring or influencing control of the issuer, should be exempted by the Commission.

Section 8. Greenmail

Section 8 of the bill adds a new subsection (h) to Section 14 of the Exchange Act, providing that any profit realized directly or indirectly, in a sale of securities to the issuer of those securities, is recoverable by the issuer, if the seller was the beneficial owner of more than three percent of the class of shares so disposed, and had held any or all of the shares for less than one year prior to the disposition. Transactions approved by a majority of the issuer's outstanding voting securities, or pursuant to an offer made on equal terms to all shareholders, would be excepted. This provision thus requires that any premium offered to such a greater than three-percent shareholder be offered to all shareholders, which would assure that all shareholders are afforded a meaningful opportunity to receive any premium pursuant to the same terms and conditions, unless a majority of the shareholders specifically approves such a repurchase in a particular case. The Commission also could exempt other persons, securities or transactions by rule or order.

The bill provides that an action to recover profits under the new subsection could be brought by the issuer, or on behalf of the issuer by any other person who owned any equity security of the issuer at the time of the transaction allegedly giving rise to liability if the issuer fails to bring the action within 60 days after request or if the issuer fails diligently to prosecute the action. No action could be brought more than two years after the date the profit was realized. In addition, since, with respect to transactions that would be governed both by this section and by Section 16(b) of the Exchange Act, the class of plaintiffs would be identical, the bill specifically precludes double recovery.

A number of states have adopted statutes regulating the same transactions to which this provision is directed; *i.e.*, the repurchase by the issuer of its own shares at a premium from a substantial shareholder. Likewise, applying state corporate law fiduciary principles, the courts are evolving standards governing such transac-

tions. This provision is not intended to preempt or otherwise affect such state laws, but rather to supplement them.

Section 9. Registration and Regulation of Arbitrageurs

Section 9 adds a definition of "tender offer arbitrageur" to the Exchange Act and requires all "tender offer arbitrageurs" to register as such with the Commission pursuant to Section 15 of the Exchange Act. This provision subjects such entities, who may be intimately involved in putting companies into play, to examination by the Commission and the Commission's net capital rules, and requires detailed record keeping of transactions.

Although the current definition of a dealer includes many of those who engage in tender offer arbitrage, the new definition of tender offer arbitrageur is more broadly drafted to reflect the remedial nature of this legislation. In recognition of the broad coverage of the definition, however, certain persons that have not traditionally had significant roles in tender offer arbitrage, or that are currently subject to a comprehensive scheme of federal regulation, have been excluded. In addition, the bill gives the Commission broad authority to exempt from the definition of a tender offer arbitrageur persons whose activities do not raise concerns addressed by the legislation.

Section 10. ERISA Amendments

Section 10 of the bill amends the Employee Retirement Income Security Act of 1974 ("ERISA"). In recent years, employee benefit plans have played a major role in some tender offers. ERISA currently imposes certain duties upon plan fiduciaries, including the duty to act as a "prudent man." The effect of the prudent man standard, coupled with competitive market forces, has been to force plan investment managers to focus on short-term profits rather than long-term investments and concerns. The bill clarifies and emphasizes the fact that consideration of the long-term interests of participants and beneficiaries is consistent with the fiduciary's obligations. The bill provides that, in voting upon a merger, combination or sale of substantially all the assets of, or in tendering or refraining from tendering securities in a tender offer for, a publicly-owned business the securities of which constitute assets of a plan, a fiduciary must take into consideration the long-term as well as the short-term interests of the participants and beneficiaries of the plan. A fiduciary would not be deemed to have violated its fiduciary responsibility under Part 4 of ERISA solely because he takes such interests into consideration.

Section 10 of the bill also amends provisions of ERISA relating to the termination of a plan and the distribution to the employer of the residual assets in excess of the liabilities. ERISA currently permits such termination and distribution, if the distribution does not violate any law, and if the plan so provides. The bill prohibits such a distribution if any part of the residual assets of the plan are used to finance, directly or indirectly, any acquisition of the employer's securities pursuant to a tender offer subject to the Exchange Act by a person (including a group acting to acquire the employer's securities or to influence its management), or any acquisition of such securities in a transaction subject to Section 13(e) of the Exchange

Act, which is applicable to self-tender offers by the issuer. The prohibited distributions includes the repayment, redemption or refinancing of any indebtedness incurred by such person in connection with any such acquisition. The subsection would not apply to a transaction described in Section 4980(c)(3) of the Internal Revenue Code of 1986 (governing certain transfers to employee stock ownership plans) as in effect on the date the bill is enacted as long as such transfers are approved, by majority vote, of all participants in the employer pension plan prior to the reversion of plan assets. For purposes of this provision, "employer" would include any person that, directly or indirectly, owns or controls 50 percent or more of the voting power or total value of the outstanding stock of an employer.

Section 11. Increased Access to Proxy Statements for Shareholders

Section 11 of this bill amends Section 14(a) of the Exchange Act to require the inclusion in the issuer's proxy statement, and any supplemental proxy statements or amendments to the extent the Commission so designates, or descriptions or statements with respect to any issue to be presented for shareholder vote, including the election of directors, when such descriptions or statements have been submitted by beneficial owners of at least ten percent of the issuer's voting securities acting together. Where descriptions and statements are required, they would have to receive equal space, coverage and treatment as is afforded the issues and positions on such issues of (or candidates nominated by) the issuer's board of directors or management. The implementation of this requirement would be subject to Commission rules with respect to eligibility, timing, the resolution of disputes between proponents of materials and issuers and the standards by which such disputes should be resolved, and other related procedural matters.

Section 12. Chinese Wall Procedures

Under current law, multi-service broker-dealers are not required to establish any specified procedures, such as an organizational separation between departments, to prevent interdepartmental communication of material nonpublic information, although most firms do adopt such procedures in order to avoid potential liability, including liability under Sections 10(b) and 14(e) of the Exchange Act and Rules 10b–5 and 14e–3 thereunder. Nevertheless, in recent years numerous instances of improper trading in merger and acquisition stocks by highly placed investment professionals have come to light.

Congress has previously addressed the importance of broker-dealer internal surveillance and compliance systems. Existing Section 15(b)(4)(E) states that no person shall be deemed to have failed reasonably to supervise any other person if there have been established procedures, and a system for applying such procedures; that authority is, however, corrective rather than preventative. Section 12 of the bill amends Section 15(c) of the Exchange Act to reaffirm the Commission's authority to establish minimum guidelines to prevent the misuse of confidential information.

Section 13. Insider Reports

Section 13 of the bill amends Section 16(a) of the Exchange Act. Section 16(a) currently requires officers, directors and beneficial owners of at least ten percent of a class of most publicly traded equity securities, to file a statement of ownership with the Commission and any exchange on which the security is traded, within ten days after becoming subject to the section. Any change in ownership must be reported within ten days after the end of the month in which it occurred. Section 13 of the bill shortens the time period for filing statements of change in beneficial ownership to five days after the change occurs. The bill requires that the statement include a description of the change, the filing person's prior ownership and his resulting ownership.

Section 14. Increased Penalties for Insider Trading, Perjury, and Obstruction of Justice

Section 14 of the bill amends Section 32 of the Exchange Act to increase the criminal penalties for willful violation of the Exchange Act, or rules thereunder, by communicating or trading a security while in possession of material, nonpublic information. Section 32 currently imposes a maximum fine of $100,000 or five years imprisonment, or both. The effect of the Criminal Enforcement Act of 1984 was to increase the criminal fines for insider trading and most other securities law violations to $250,000 for individuals and $500,000 for organizations, or twice the pecuniary gain to the offender or loss to the victim, if that amount is higher. The bill establishes a maximum fine of $1 million or ten years imprisonment, or both for insider trading violations. Transactions that are part of a public offering by an issuer of securities other than standardized options would be excluded. The bill also imposes a mandatory penalty of one-year imprisonment for willful violations of Section 1505, 1510, 1621, or 1622 of title 18, United States Code (generally governing perjury and obstruction of justice), if the violation of such sections occurred in the course of an investigation of a violation of the Exchange Act relating to the trading of a security while in possession of material, nonpublic information. The one-year term would be in addition to, and served consecutively with, any other term of imprisonment for the violation.

Section 15. Role of State Law

Section 15 of the bill requires the Comptroller General of the United States, in consultation with the Commission and the North American Securities Administrators Association, to conduct a study of state laws regulating tender offers and other changes of corporate control. In its recent *CTS Corp.* v. *Dynamics Corp.* decision, 107 S. Ct. 1637 (1987), the Supreme Court reaffirmed that certain state corporate laws which may affect control contests are not preempted by the federal securities laws and do not necessarily burden interstate commerce. That decision emphasizes the importance and sensitivity of delineating the proper relationship between state and federal law in the control contest area. The study should review state laws adopted between January 1, 1982 and January 1, 1989, and examine the effect such laws have on the number

of takeovers attempted and completed, the rights and economic well-being of shareholders of companies subject to such laws, and the impact such laws have on employment. A report would be submitted to Congress by October 1, 1989. The ordering of such a study in no way is intended to reflect upon the Supreme Court's decision or to affect continuing judicial resolution of these issues.

Section 16. Commission Studies

Section 16 of the bill directs the Commission to conduct a study of the proxy voting process. The bill requires the Commission to consider proposals intended to make corporate management more responsive to shareholder concerns expressed through proxy voting, and to consider whether proxy voting should be confidential, and whether bidders should have access to proxy machinery on an equal basis with management.

Section 16 of the bill also requires the Commission to conduct a study of leveraged buyouts and other going private transactions in which securities of an issuer are purchased by management. Pursuant to its authority, the Commission has adopted rules and regulations providing disclosure requirements with respect to such transactions. The bill requires the Commission to study proposals for more extensive disclosure. In particular, the Commission is required to examine whether adequate disclosure is provided to shareholders in such transactions, whether significant conflicts of interest exist in such transactions and whether shareholders or other corporate stakeholders are being harmed by such conflicts, and whether appropriate appraisals of the fairness of the offer to take the corporation private are being made available to shareholders and the public. The Commission would be required to submit a report on the results of the studies conducted under this section to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Energy and Commerce of the House of Representatives.

Section 17. Study of One Share/One Vote

Section 17 requires the Commission to review any and all rules, including listing standards, stated policies, practices, and interpretations, of national securities exchanges and national securities associations relating to shareholder voting rights. The Commission is required to report to Congress, by October 1, 1988, the results of its review, including the effects of such rules on investor protection and the established system of state corporate governance laws which governs shareholder voting rights.

Regulatory Impact Statement

In compliance with paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the Committee makes this assessment regarding the regulatory impact of the bill. Since the bill, in large part, merely amends longstanding regulatory requirements created by earlier legislation, the increase in regulatory burden from this legislation will be minimal. To the extent that any substantive increased regulatory burden may be attributed to the bill, it may include the potential, in some instances, for broadened disclosure

under pre-existing disclosure obligations; the possible application of existing regulatory requirements governing tender offers to limited instances of share acquisitions above 25% ownership; a potential burden on corporations to provide proxy access for certain shareholders; and in applying the existing broker/dealer registration provisions to what will likely be, according to present indications, a very small group of business entities engaged in tender offer arbitrage which are not already registered or otherwise subject to appropriate regulation.

Changes in Existing Law

In the opinion of the Committee, it is necessary to dispense with the requirements of subsection 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

Cost of Legislation

The Committee has requested a cost estimate of this legislation under the provision of Section 403 of the Congressional Budget Act of 1974. The cost estimate of the Congressional Budget Office appears below:

U.S. Congress,
Congressional Budget Office,
Washington, DC, November 19, 1987.

Hon. William V. Proxmire,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.

Dear Mr. Chairman: The Congressional Budget Office has reviewed S. 1323, the Tender Offer Disclosure and Fairness Act of 1987, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs, September 30, 1987. We expect that implementation of the bill would result in costs of less than $1 million to the federal government.

S. 1323 contains a number of provisions aimed at reducing the chances of a company being taken over through a hostile stock buyout bid. Specifically, the bill would tighten federal disclosure requirements for takeover activities by requiring that investors notify the Securities and Exchange Commission (SEC) within 24 hours after purchasing more than 5 percent of a company's stock. The bill would extend the minimum amount of time that tender offers must remain open from 20 to 35 business days. The bill would also require that the names of individuals involved in takeovers be filed with the SEC to assist detection of stock trading based on inside information. In turn, penalties would be increased for illegal stock trading on inside information. A number of other changes to existing law are included in the bill.

In addition, the bill would require the General Accounting Office and the SEC to conduct a number of studies regarding tender offers. We expect completion of these studies to cost less than $1 million over the next two years. Other provisions of the bill are not expected to result in significant cost to the federal government.

No costs would be incurred by state or local governments as a result of enactment of this bill.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes.

Sincerely,

ROBERT F. HALE
(For Edward M. Gramlich, Acting Director).

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

S. 1323 as reported by the Committee is a constructive and reasonable response to some of the more serious abuses that have recently arisen in the field of corporate takeovers. While the legislation does not go as far as I would have preferred in some areas, it does nonetheless represent a major improvement in our securities laws as they affect corporate takeovers. The legislation will go a long way towards protecting the rights of shareholders in corporate takeover contests as well as maintaining the confidence and trust of the investing public in the basic integrity of our securities markets. The Committee's report does an excellent job in laying out the need for this important legislation.

I would also commend to the attention of the Senate the excellent additional views of Senators Sasser, Sanford, and Chafee. While these views in no way conflict with the Committee's report, they do set the issue of corporate takeovers in a somewhat broader context, particularly with respect to the relationship between takeovers and the rise of corporate debt and the importance of the role of the states in regulating corporate conduct. I find myself in substantial agreement with these views and I urge that they be read along with the main body of the Committee's report. Taken together, the Committee's report and the Sasser/Sanford views provide a compelling case for the need to reform corporate takeovers.

BILL PROXMIRE.

ADDITIONAL VIEWS OF SENATORS SASSER, SANFORD, AND CHAFEE

I. Introduction

While we heartily concur with the report submitted on behalf of the Committee, we believe that two points deserve further elaboration. First, those who defend the current corporate takeover process do so largely by claiming that hostile takeovers are a means to oust inefficient management and thereby produce a more competitive corporate America. Economic evidence of which we are aware demonstrates that corporate takeovers, especially hostile ones, have usually been directed instead at *efficient* management, have not generally resulted in more competitive corporations, and have caused significant hardship to many corporate constituencies. While we do not believe all takeovers are bad, nor that all takeovers should be stopped, we do feel that a greater understanding of the facts is warranted as well as a greater appreciation of the detrimental economic effects that result.

Second, while we applaud the comments in the Committee's Report concerning the role of the states in corporate governance, we believe the threat of legislative federal preemption remains very real, whether through a direct amendment or through backdoor preemption in the form of a "one-share/one-vote" amendment. As such, we would like to emphasize the importance of reaffirming the role of the states in regulating the internal affairs of corporations.

II. The Economic Evidence: Hostile Takeovers Do Not Guarantee Greater Efficiency

A. TARGET CORPORATIONS ARE GENERALLY WELL RUN

Proponents of takeovers, especially hostile ones, (which we would define as those that have not been approved by the target's board of directors) argue that such takeovers remove incompetent, entrenched management in poorly run, weaker companies. This claim is not supported by the historical and economic record.

A look at the companies that have recently been subject to attack—for example, Borg-Warner, Owens-Corning Fiberglass, Goodyear, Holiday, Dayton Hudson, ITT and Burlington Industries—indicates that the target companies have a better than average return on equity when compared to their industry, or that they are otherwise considered to be well managed.[1] Alan Greenspan, now Chairman of the Federal Reserve Board of Governors, observed: "One would assume that the least well-run companies gen-

[1] Dobrzynkski, *More Than Ever, It's Management for the Short Term*, Business Week 93 (November 24, 1986).

erally were subject to takeovers. Cursory evidence of particular takeover targets suggested that the evidence is mixed, at best. A number of rather well-run or improving companies have been the subject of successful takeovers merely because their stock prices have not fully reflected their improved status." [2]

Professor Edward Herman of the Wharton Business School and Professor Louis Lowenstein of Columbia Law School studied 25 targets of hostile takeovers during the period 1981–1983 and found companies whose return on equity averaged a very healthy 15.9 percent for all three years and over 18 percent during the last two years, *not* inefficient companies in need of restructuring.[3]

Others have reached similar conclusions. W.T. Grimm and Co. studied over 750 tender offers from 1974 to 1984 and noted that, unlike earlier years, many of the participants in the hostile as well as friendly deals were "large, well established concerns acquiring financially healthy and well-managed companies enjoying strong market positions. The acquired companies, in most cases, ranked first or second within their industries." [4] Likewise, Professor Donald Margotta of Northeastern University College of Business Administration and Professor Felicia Marston of Boston College, after analyzing a series of studies on tender offers and examining 48 takeover targets and 44 rejected tender offers, stated that their data "do not support the hypothesis that [target] companies were poorly managed relative to their industry counterparts." [5]

B. HOSTILE TAKEOVERS DO NOT CREATE MORE EFFICIENT COMPANIES

Successful hostile takeovers are claimed to improve the performance of the target company. Significant economic evidence does not support that contention. In fact, once companies are acquired through a takeover, performance often deteriorates. In a major economic study, Professor David Ravenscraft of the Business School of the University of North Carolina and Professor F.M. Scherer of Swarthmore College examined tender offer acquisitions of companies involving 150 separate manufacturing lines of business and found that "having been subject to a takeover of any sort was associated with a significant negative impact on profitability. . . . [T]he average observed tendency was for operating income/assets ratios to *decline* following takeover through tender offer." (Emphasis in original.)[6]

Similarly, Professors Margotta and Marston, after analyzing a variety of data and reports on 48 defeated tender offer attempts, concluded that, in the long run, shareholders were not disadvantaged where companies defeated tender offers.[7] This study shows

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[2] *Hostile Takeovers: Hearings before the Senate Committee on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 42 (January 28, March 4, and April 8, 1987) [hereinafter cited as *Senate Hearings on Hostile Takeovers*] (statement of Alan Greenspan).

[3] Herman and Lowenstein, The Efficiency Effects of Hostile Takeovers 53–54, Working Paper #20, The Center for Law and Economic Studies, Columbia University School of Law (Revised April 1986) [Note: permission needed to quote or cite this paper].

[4] W.T. Grimm & Co., *Mergerstat Review 1984* 7 (1985).

[5] Margotta and Marston, Long-Term Results of Defeated Tender Offers 24 (July, 1987), Northeastern University College of Business Administration Working Paper 87–29.

[6] Ravenscraft and Scherer, *Mergers and Managerial Performance*, in *Knights, Raiders and Targets: The Impact of the Hostile Takeover* (Coffee, Lowenstein, Rose-Ackerman, eds., forthcoming, 1988).

[7] Margotta and Marston, *supra* note 5, at 20.

that target company shareholders do not benefit in the long run from hostile takeover activity, even if such shareholders might experience short term financial gains.

Moreover, these short term gains must be factored against the detriment to bidder shareholders. Professor Dennis Mueller of the University of Maryland and Professor Ellen Magenheim of Swarthmore College studied 78 acquisitions (51 mergers, 26 tender offers, and one unclassified transaction) from the point of view of shareholders of the acquiring company and concluded that "three years after the acquisition, shareholders were significantly worse off than they would have been had their companies continued to perform in the post-event period . . . as they had prior to the event. . . ." [8]

Indeed, the argument that takeovers will result in greater corporate efficiency is belied by the fact that so few raiders actually end up acquiring and running the corporations they go after. Many takeover threats are not engaged in by operating companies but by "raiders" who put companies in play with the expectation that they will earn profits by being bought out at a higher price in a recapitalization, by selling shares to new bidders or "white knights", be selling back to the company at a premium, via greenmail, or by selling in the market after the market price has increased following announcement or rumor of the tender offer. The raider rarely takes control. Therefore, the raids often do not serve to remove incompetent management but to earn quick profits for the bidders from the target company.

David Roderick, Chairman and CEO of USX Corporation, noted: "We seem to have evolved a legal mechanism that allows massive abuses by a small group of raiders, arbitrageurs, promoters, and investment bankers, who reap enormous profits serving only their own self-interest at the expense of stockholders, employees, creditors, communities, and the nation at large." [9] Mr. Roderick's views are widely shared by the American public. The results of an opinion poll conducted by Louis Harris indicates that the American public (by 78 to 19 percent) believes that most hostile takeovers "are engineered by groups of big investors . . . trying to drive up the price of stock just to make a profit for themselves." [10]

1. Other Cures of Inefficient Management Are Effective

Hostile takeovers must not be seen as the only way that corporate management is energized to productively utilize corporate assets. Boards of directors frequently remove poor management; the average turnover rate for management is five to seven percent in big corporations.[11] Directors of corporations already have a fidiciary duty to the shareholders not to take actions that would be detrimental to the value of the shares. If management entrenches itself, the directors may be held liable in a shareholder suit.

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[8] Magenheim and Mueller, *On Measuring the Effect of Acquisitions on Acquiring Firm Shareholders*, in *Knights, Raiders and Targets: The Impact of the Hostile Takeover* (Coffee, Lowenstein, Rose-Ackerman, eds., forthcoming, 1988).

[9] *Senate Hearings on Hostile Takeovers* (statement of Felix Rohatyn, Senior Partner, Lazard, Freres & Co.) at 42.

[10] *Senate Hearings on Hostile Takeover* (testimony of David Roderick, Chairman and CEO, USX Corporation) at 130.

[11] Louis Harris, Testimony before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee (April 1, 1987).

In addition, companies act on their own in a "friendly" context to divest or restructure divisions that can better be used elsewhere: last year there were over 1,200 divestitures as compared with about 40 hostile takeover attempts.[12] Indeed, corporate leaders are under constant pressure from domestic and international competitors to improve the efficiency and profitability of their companies; hostile takeovers are not the critical catalyst to motivate worthwhile restructurings.

2. Other Productive Economies Do Not Permit Hostile Takeovers

It is significant to note that the institutional structures of other nations such as Japan and West Germany preclude hostile takeovers for all practical purposes, yet those nations have strong economies. These nations do not seem to need the so-called "efficiency enhancing" mechanism of a hostile takeover.

C. THE IMPACT OF HOSTILE TAKEOVERS

In measuring the need for regulation of hostile takeovers, we believe we must consider the long-term losses absorbed by this nation's economy and its employees, companies, communities and others against the short-term gains of corporate raiders and some target shareholders. We believe we must all recognize that many takeover threats produce sizable profits for raiders who invest comparatively little, who frequently have no intention of managing the target company, and whose gain often comes only at the expense of many others. Specifically, we believe any short-term gains that might result from takeovers are often outweighed by: (1) the tremendous corporate debt created; (2) the loss of jobs; (3) the detrimental effect on the community; (4) the reduction in research and development expenditures; (5) the increased volatility and overvaluation of the stock market; and, perhaps most importantly, (6) the shift to a short-term focus.

1. The Negative Short- and Long-Term Effects of Increased Corporate Debt

Over the course of the last three years, nonfinancial corporations increased their debt load by more than $650 billion. Total nonfinancial corporate debt has reached nearly $2.5 trillion, or approximately $10,000 for every man, woman and child in the United States.[13] Much of this debt load is a direct result of hostile takeovers and, equally important, efforts to thwart such takeovers. For example, Scovill is suffering from the staggering debt load of $400 million that it acquired when the Belzbergs took over the company. Burlington Industries is now burdened with an additional $2.5 billion in debt as a result of a leveraged buyout to defeat an offer from Asher Edelman. As a reaction to offers from T. Boone Pickens and Carl Icahn, Phillips Petroleum incurred $4.5 billion in new debt, causing the percenage of its total debt to total capital to nearly triple to 80 percent. Similarly, Owens-Corning Fiberglass

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[12] Hayes, *Pickens All Set for New Game*, The New York Times, January 26, 1987, at D-1 and D-5.

[13] *Making Money From Takeover Bids; The Hafts: Retailers or Raiders?* and *Dart Group Chronology*, Los Angeles Times, August 20, 1987, at part 4, page 4.

saddled itself with $2.6 billion in debt in its fight with Wickes Companies, Inc. Robert Mercer, the Chairman and CEO of Goodyear, described his company's $4 billion debt load to defend against Sir James Goldsmith as "one which will leverage the Comapny to an unprecedented 80 percent of debt to total capitalization." [14]

Indeed, the hallmark of most hostile takeovers is the conversion of huge amounts of equity to debt. To acquire the stock of their target, bidding companies borrow large sums of money, most of which is secured by pledging the assets of the takeover target. For example, in 1985, MAXXAM corporation made a successful contested bid for Pacific Lumber. The financing consisted of a short-term $300 million bank loan and $450 million in high-yield or "junk" bonds. The annual interest payments on the bonds (beginning in 1989) are more than Pacific's historical annual profit. MAXXAM has stated that it will terminate Pacific's pension plan, sell its headquarters and all nontimber assets to pay off the bank loan, and will drastically increase cutting of environmentally significant redwoods to pay off the bonds.[15]

Indeed, our concern is that once a company is "in play", the question becomes *whose* debt the company will take on—its own, a white knight's or the raider's—not *whether* such debt will or should be incurred. For in the case of unsuccessful hostile threats, target companies also are forced to assume debt to repurchase shares from the raider. Moreover, equally damaging to the aggregate economy is the practice, by companies that are, or perceive themselves to be, threatened by takeovers, of incurring debt solely to make their balance sheets less attractive and to make it more difficult for their assets to be divided and sold. Data Resources estimated that, by the end of last year, the average American company's debt was equal to approximately 90 percent of its net income, representing an increase of over 25 percent compared to past treads.[16]

As corporations take on historically high levels of debt to finance repurchases of their own stock, to decrease their appeal to raiders, or to finance the acquisition of target companies, their equity base decreases. Debt at 30 percent of equity is often considered prudent for non-utilities, yet, company after company involved in takeovers is incurring debt levels of 80 percent or more.[17] As a result, unobligated cash flow is stifled. Former securities and Exchange Commission Chairman John Shad summed up the effects of these debt-financed takeovers in stating: "the greater the leverage, the greater the risk to the company, its shareholders, creditors, officers, suppliers, customers and others . . . the more leveraged takeovers and buyouts today, the more bankruptcies tomorrow."[18]

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[14] *Senate Hearings on Hostile Takeovers* at 216 (testimony of Robert Mercer, Chairman and CEO, Goodyear Tire & Rubber Co.).

[15] *See* Terry, *Maybe the Belzbergs should stick to Raiding*, Business Week 107 (December 9, 1985); Memorandum to Members of the House Subcommittee on Oversight and Investigations of the Energy and Commerce Committee from chairman John D. Dingell on Hearings on Pacific Lumber (October 5, 1987). *See also*, Nussbaum, *Takeover Battles Trigger Battle Over Redwoods*, Washington Post, August 30, 1987, at H-5.

[16] Potts, *Corporate Debt Raises Controversy; Analysts Disagree on Impact on Big Business*, Washington Post, January 11, 1987, at G-1.

[17] *Id.*

[18] 133 Cong. Rec. S7600 (daily ed. June 4, 1987) (statement of John Shad, as quoted by Chairman Proxmire).

Harvard University economist Benjamin Friedman reports that interest costs on outstanding debt are "eating up more than 50% of pretax earnings [as compared with] less than 40% in the 1970s and less than 20% in the 1960s."[19] He adds that these new debtors "are not borrowing in the traditional way, to put up a new plant . . . They're borrowing to retire equity. That doesn't do anything to increase cash flow. It just increases obligations."[20]

While corporations with heavy debt loads may be able to finance their obligations if interest rates remain constant, notwithstanding the significant opportunity costs of this allocation of funds, it is clear to us that a downward turn in the economy could spell failure for many businesses. Unlike shareholder dividends, obligations to creditiors cannot be postponed until the economy strengthens.

Increased debt has lowered the credit rating that many companies have received from the bond-rating agencies. For example, Standard & Poor's down-graded Scovill's commercial paper to CCC—its second-lowest speculative rating, noting that it "couldn't be any lower without the company going into default."[21] Discerning a negative trend in bond quality, experts estimate that the number of AAA-rated industrial and utility corporations has dropped by 50 percent over the last decade. Standard & Poor's records reveal that while the number of industrial-bond upgrades has changed little since 1981, the number of downgrades has more than tripled. For example, in 1986, three times as many corporate bonds were downgraded as were upgraded.[22] According to Standard & Poor's, a large portion of downgrades were the result of increased credit risks due to leveraged takeovers, buyouts and recapitalizations.[23]

We believe that this accumulation of debt by corporations reduces their options and increases their risk at a time when increased competition makes broader room for manuevering essential.

2. Loss of Jobs

Firm evidence indicates that hostile takeovers, both successful and unsucessful, have led directly to the elimination of jobs. While the maintenence of a reasonable corporate cost structure is an ongoing responsibility of management, there is a difference between corporate-initiated streamlining and the significant wholesale layoffs due to external factors. Employment was reduced by almost 50 percent at Burroughs, more than 30,000 jobs were eliminated at Safeway, the merger of Gulf Oil and Socal resulted in the loss of 27,000 jobs and 40 percent of the salaried work force was eliminated at Owens-Corning Fiberglass.[24] In all, it has been estimated

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[19] Dobrzynkski, *supra* note 1.
[20] *Id.*
[21] Terry, *supra* note 20, quoting Standard & Poor's.
[22] *Bondholders Fight Back Against Takeover Losses*, IRRC Corporate Governance Bulletin, 156, 157 (September/October 1987).
[23] Altany, *supra* note 18, at 45.
[24] *Bondholders Fight Back Against Takeover Losses*, *supra* note 27 at 157.

that 500,000 jobs have been lost in the aftermath of takeover attempts in the past three and one-half years.[25]

These jobs and many like them are often lost because companies have slashed operations and sold assets to service massive debts incurred in connection with hostile takeover attempts. For example, to pay off the debt incurred in its hostile takeover of Scovill, the Belzbergs cut corporate staff by 30 percent and division staff by 10 percent, instituted forced retirements and planned to strip the company of other assets.[26] The AFL-CIO's Treasurer, Thomas Donahue, asserts that "at a minimum, roughly 80,000 members of unions that are affiliated with the AFL-CIO have been thrown out of work as a direct result of corporate restructuring." [27] This reduction in employment has not increased profitability; rather, there has been a direct transfer of wealth from employees to target company shareholders.[28]

Promised benefits for surviving workers are often at risk as new or embattled corporate managers break implicit contracts. Employees suffer when corporate raiders use momentarily overfunded pensions to pay off their debt. Describing the "rising number of pension plan terminations" as "one ominous barometer . . . signaling the profound alterations of a corporate social compact," Jack Sheinkman, Secretary-Treasurer of the Amalgamated Clothing and Textile Workers Union, cited as an example Reeves Brothers which agreed to terminate its pension plans in order to honor creditor obligations contained in the loan agreement that allowed Reeves to be bought out by Schick.[29] These repercussions not only affect the workers whose retirement income may be jeopardized or whose wages are cut but also affect the language of future union contracts.[30]

Worries of job security become more manifest. The fear of losing a job or receiving a pay cut to finance corporate debt obligations lowers employee morale and productivity.[31] Seniority is affected, as are other expectations that workers develop through years of employment. As Professor Peter Drucker writes, "[t]he fact that, almost without exception, the result of the hostile takeover is also the demoralization and severe impairment of the human organization, disproves the argument that the hostile takeover results in a more efficient allocation of resources. . . . It does severe damage to the true productive resource, the human organization, its spirit, its dedication, its morale, its confidence in its management, and its identification with the enterprise that employs its people." [32]

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[25] *See* Sanger, *Burroughs to Slash Payroll by 8 Percent*, The New York Times, October 9, 1987, at D-9; Mayer, *One Year After the Hafts' Bid, Safeway is Leaner, More Efficient*, Washington Post, August 30, 1987, at H-1; O'Brien and Kline, *An Rx for Jobs Lost Through Mergers*, The New York Times, February 22, 1987, at section 4, page 23.

[26] Terry, *supra* note 20.

[27] *Senate Hearings on Hostile Takeovers* at 262 (testimony of Thomas Donahue, Secretary-Treasurer, AFL-CIO, citing *Business Week*).

[28] *Senate Hearings on Hostile Takeovers* at 262.

[29] *Senate Hearings on Hostile Takeovers* at 330 (testimony of Jack Sheinkman, Secretary-Treasurer of the Amalgamated Clothing and Textile Workers Union).

[30] Shleifer and Summers, *Breach of Trust in Hostile Takeovers* 16–18 (June 1987) (unpublished manuscript).

[31] *See, e.g.*, O. Williamson, *Corporate Control and Business Behavior: An Inquiry Into the Aspects of Organizational Form on Enterprise Behavior* (1970). *See also*, Magnet, *Help! My Company Has Just Been Taken Over*, Fortune 45 (July 9, 1984); Prokesch, *People Trauma in Mergers*, The New York Times, November 19, 1985, at D-1.

[32] P. Drucker, *The Frontiers of Management* 243 (1986).

3. Detrimental Effect on the Community

The adverse impact of takeovers is also felt by the community in which the target company is located. Lost wages translate into lost municipal revenue and social harm, at a time that demand for social services is increasing dramatically. For example, the major restructuring of Phillips Petroleum to fight off Pickens has had severe adverse effects on the community of Bartlesville, Oklahoma, where Phillips is the dominant employer. A Bartlesville retailer, Mr. Michael May, complained that "Phillips survived—but at tremendous costs. Regardless of the outcome, one thing becomes painstakingly clear—neither the company nor the town will ever be the same again." [33] Phillips was forced to cut 2,700 jobs in Bartlesville, and, as Mr. May testified: "A reduction of 2,700 jobs in the city the size of Pittsburgh or Kansas City is a major concern to economic stability. In a community of 36,000, it is a disaster." [34] Mayor Archie Robbins characterized T. Boone Pickens as a raider who "says he's for the little guy, but goes away as a multimillionaire . . . ." [35] Indeed, many other towns have been adversely affected by corporate takeovers, among them Cumberland, Maryland; Bristol, Tennessee; Newark, Ohio; Barrington, New Jersey; as well as large cities such as Pittsburgh, which was hurt when Chevron acquired Gulf following a raid by Pickens. As James Hatfield, International President of the Glass, Pottery, Plastics & Allied Workers, observed: "Whether a takeover bid is successful or not has little bearing . . . . Employees, their families, and their communities are the innocent bystanders injured during these transactions . . . ." [36]

4. Reduction of Expenditures for Research and Development

It is estimated that in 1986, for the first time in history, the total cost of mergers and acquisitions will exceed spending by American manufacturers on plant and equipment.[37] Managers who bear heavy debt burdens are simply slashing research and development budgets and cutting capital expenditures. Following takeover attempts, Burlington Industries closed its research and development plant; Goodyear made significant cutbacks in its research and development program and has reduced capital expenditures by $275 million; Reeves Brothers cut its capital expenditures almost in half pursuant to an agreement with its lenders; and Safeway cut its research budget in half. As a March 11, 1985 story in Forbes predicted "When companies start worrying about sharks, practically the last thing they care about is tomorrow. As a result, one of the first items to go in corporate restructuring is the R & D budget. Long-range planning is pushed to the back burner when companies attempt to thwart current takeover attempts. . . ." [38]

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[33] Michael May, Statement before the House Energy and Commerce Subcommittee on Transportation, Tourism and Hazardous Materials (August 16, 1987).
[34] *Id.*
[35] Gapay, *The City Boone Pickens Wounded*, Seattle Post-Intelligencer, August 10, 1987.
[36] *Senate Hearings on Hostile Takeovers* at 323 (statement of James Hatfield, International President, Glass, Pottery, Plastics & Allied Workers).
[37] *Senate Hearings on Hostile Takeovers* at 1 (statement of Chairman Proxmire).
[38] Forbes, March 11, 1985, p. 87.

The transfer of resources away from exploratory research, modernization, product development, and market expansion in order to support takeover tactics and defenses comes at a time when foreign competition is capturing increasing market shares and forcing American managers to increase productivity and product quality. Goodyear Chairman and CEO Robert Mercer explains that "foreign competitors already are making investments we cannot match here in the United States and they must take great comfort in seeing our [corporate] board and our management concentrate on debt service and debt reduction at the expense of investment in technology and development." [39]

5. Adding to the Volatility and Overvaluation in the Stock Market

Following the dramatic 508 point drop in the Dow Jones Industrial Average on October 19, 1987, analysts have increasingly focused attention on the extreme overvaluation of the market as one of the causes of the crash. Indeed, there is significant evidence of overvaluation: in August 1987, the market, as measured by the Standard & Poor's 500-stock index, was trading at an extraordinary 23 times earnings, when 14.5 times earnings is considered the norm.

According to the Wall Street Journal, it was the shift to using "break up value"—the value of a company if dismembered and its parts sold off—as the cornerstone stock valuation method, rather than more traditional measures such as yield ratios, earnings, and book values that led to the enormous rise in stock prices. "The concept of breakup value came into prominence as a direct byproduct of the feverish takeover boom and everything that went with it: arbitrage, leverage, junk bonds, even inside information [and the belief that] higher prices would come from takeovers, restructurings and corporate stock repurchases alone. . . . As one company was taken over, the stock of every company in that industry would be hurriedly bid up. . . . Dazzled by huge fees, ever-rising stock prices and the corresponding ability to return privatized companies to public hands at astronomical profits, investment bankers began thinking it was impossible to overpay for a company." [40]

Other prominent observers have pointed to takeovers as the cause of the overheating of the market. In particular, the head of the Presidential task force investigating the crash, former Senator Nicholas F. Brady, has cited takeovers as a reason the stock market was so "incredibly high by all the standards usually used to measure it." [41]

Moreover, Robert B. Reich, of Harvard University, recently wrote that "[T]he anomaly through it all was the Wall Street bull market, which surged upward in seeming disregard of the underlying decline [of the eocnomy]. One big reason: Stock prices were responding in large measure not to the real economy but to takeovers, or threats of take overs, which prompted corporations to do whatever was necessary to raise their share prices in the short

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[39] *Senate Hearings on Hostile Takeovers* at 217.
[40] Wall Street Journal, December 11, 1987, p. 1, 14.
[41] Wall Street Journal, December 11, 1987, p. 14.

term. Often this meant purchasing their own shares and thus going deeply into debt and jettisoning long-term projects." [42]

6. A Resulting Short-Term Focus

A looming threat of becoming the target of a takeover has forced managers to reorient their investment and planning strategies. Professor Peter Drucker observed that "the fear of the raider is undoubtedly the largest single cause for the increasing tendency of American companies to manage for the short term and let the future go hang." [43] Results received from over 240 of the 1,200 largest member companies of the National Association of Manufacturers ("NAM") reveal findings similar to those of other business polls: that over 50 percent of the responding companies believe it is possible for them to be put in play for a short-term stock price run-up under current Williams Act rules; that an amazing 45 percent of the respondents have been the subject of takeover rumors; and that 36 percent of the companies have experienced unusual or unexplained high trading volumes in their stock.[44] Startled by these results, a NAM official cited the survey as "[s]ignificant evidence that hostile takeovers potentially threaten the majority of American companies, especially the better managed ones." [45]

Managers feel the need to sacrifice long-term investment strategies conceived to maintain their competitiveness in the marketplace in order to avoid a short-term takeover threat. As TRW, Inc., economist Pat Choate observed with respect to corporate managers, "[t]hey're too busy fighting Wall Street to fight Japan. How can anyone concentrate on doing what is needed for long-term competitiveness—spending for plant and equipment, research and development, and job training—when they're so busy battling for survival." [46]

Investment banker Felix Rohatyn used the restructuring of the oil industry, for which T. Boone Pickens claims credit, to emphasize the detrimental effect of takeovers on long-term needs:

> The mergers of Chevron-Gulf, Occidental-Cities Service, Mobil-Superior all occurred as a result of raids or the threat of raids. The deterioration in their combined balance sheets has been dramatic. Far from being a healthy restructuring, the oil companies involved are cutting exploration sharply, a practice our country will pay for dearly when the next energy crisis occurs. With their high levels of debt, they could be in serious difficulty if the price of oil declines again. If one were to write a scenario about how to get the U.S. into trouble as far as energy is concerned, it would be hard to improve on what has happened.[47]

Corporate management's short-term focus will indisputably have a far-reaching negative impact on the future of corporate America,

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[42] Washington Post, December 6, 1987, D1, D4.
[43] Drucker, supra note 37, at 244.
[44] Letter from Stanley C. Gault, Chairman, National Association of Manufacturers, to Congressman Edward Markey (October 7, 1987).
[45] National Association of Manufacturers Press Release 87-186 (October 7, 1987).
[46] Jonas, *Do All These Deals Help or Hurt the U.S. Economy?*, Business Week 87 (November 24, 1986).
[47] Rohatyn, Statement before the House Energy and Commerce Subcommittee on Telecommunications and Finance (April 1, 1987).

particularly as corporate managers are forced into unplanned restructurings. For example, Goodyear was forced to put $1.5 billion worth of assets on the auction block after being put into play; Owens-Corning Fiberglass was forced to sell its recently acquired Aerospace & Strategic Materials Group and close a major facility in Jackson, Tennessee after defending a takeover attempt by Wickes Companies, Inc.[48]

USX Corporation Chairman David Roderick warns that "many hostile takeovers can result in such highly leveraged situations they require an immediate bustup of the enterprise to reduce debt without concern for the most efficient operation of the enterprise. This can result in a myopic compulsion to generate a quick conversion to cash at the expense of the long-term viability of the company." [49] Lawrence Chimerine, Chairman and CEO of Wharton Economics, Inc. accurately observes that "[c]orporations have overextended themselves . . . In the short-run, high debt loads hurt capital spending. Over the long-run, this will result in lower growth and productivity." [50]

As Felix Rohatyn observed, "[i]t is obvious that these restructurings are driven more by the fear of takeovers than by straightforward economic forces." [51] This dismantling of major American corporations and emphasis on the short term is a serious and real threat to the competitiveness and leadership of U.S. industry at home and abroad. As Professor Peter Drucker concluded, fear of takeovers is "contribut[ing] to the obsession with the short term and the slighting of tomorrow in research, product development, market development and marketing, and in quality of service—all to squeeze out a few more dollars in the next quarter's bottom line." [52]

III. The State Role in Regulating Corporate Governance and Contests for Control Should Be Reaffirmed

We believe Congress should explicitly reaffirm the right of the states to enact laws governing the internal affairs of corporations, and to legislate in the corporate takeover area. Approximately thirty states have enacted statutes relating to corporate takeovers under the traditional authority of the states to regulate corporate governance. We believe that these statutes are fully consistent with, and complement, the anti-fraud, disclosure and procedural requirements of the Williams Act—the federal law that governs tender offers.

A. THE TRADITIONAL ROLE OF THE STATES ON MATTERS OF INTERNAL CORPORATE GOVERNANCE AND THE CTS DECISION

Nowhere is the American principle of federalism, the careful balance between national and state authorities, more evident than in the regulation of corporations. Traditionally, the federal govern-

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[48] Dobrzynski, *supra* note 1.
[49] *Senate Hearings on Hostile Takeovers* at 132.
[50] Altany, *supra* note 18, at 44.
[51] *Senate Hearings on Hostile Takeovers* at 48 (testimony of Felix Rohatyn, Senior Partner, Lazard, Freres & Co.).
[52] *Senate Hearings on Hostile Takeovers* at 112 and 118 (statement of P. Drucker, as quoted by Chairman Proxmire).

ment has regulated financial markets and securities exchanges and has provided for a scheme of investor protection that is manifested in the disclosure, anti-fraud and procedural requirements of the federal securities laws. On the other hand, the states have been delegated sole authority for the governance of internal corporate affairs. Indeed, in *Cort* v. *Ash*, 422 U.S. 466 (1975), the Supreme Court held:

> Corporations are creatures of state law and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities with respect to stockholders, state law will govern the internal affairs of the corporation.

This balance of authority between the federal government and the states was recently affirmed by the Supreme Court in a case involving an Indiana law on corporate takeovers. In *CTS Corp.* v. *Dynamics Corp. of America*, the Court concluded that the Indiana law did constitute a legitimate part of the governance of internal corporate affairs, and that the laws' limitation on voting rights in the context of a proposed takeover was consistent with the State's "interest in promoting stable relationships among parties involved in the corporations it charters as well as in ensuring that investors in such corporations have an effective voice in corporate affairs." 107 S.St. at 1651 (1987).

Indeed, the *CTS* Court held that the regulation of internal corporate affairs to protect shareholders (including nonresident shareholders) of domestic corporations from injury caused by a change of control serves a legitimate state interest under the Commerce Clause, and that such regulation is not an impermissible burden upon interstate commerce even if it, to some extent, deters or makes more difficult certain kinds of tender offers. The Court also held that "the possibility that the Indiana Act will delay some tender offers is insufficient to require a conclusion that the Williams Act pre-empts the Act," and the court noted that "the Williams Act would pre-empt a variety of state corporate laws of hitherto unquestioned validity if it were construed to pre-empt any state statute that may limit or delay the free exercise of power after a successful tender offer." [53]

The Supreme Court in *CTS* also recognized that the Indiana law served shareholder interests. "By allowing . . . shareholders [faced with a tender offer] to vote as a group, the [Indiana] Act protects them from the coercive aspects of some tender offers. . . . The desire of the Indiana Legislature to protect shareholders of Indiana corporations from this type of coercive offer does not conflict with the Williams Act. Rather, it furthers the federal policy of investor protection." [54]

After *CTS*, a number of states adopted statutes similar to the Indiana statute, while other states have followed various model approaches in regulating hostile takeovers. All the current state statutes regulating contests for control are designed to protect shareholder interests. As such, they are a legitimate exercise of the

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[53] 107 S.Ct. at 1647 and 1648.
[54] *Id.* at 1646.

State's authority and should not, as some have suggested, be preempted by Congress.

Indeed, we believe that state laws have additional benefits.

1. State Regulation Affords Greater Flexibility to Foster and Adapt to Change

The state laws regulating contests for control supplement the federal procedure and disclosure laws but, most importantly, these statutes have enabled state legislatures to address evolving takeover abuses on a current basis. States are able to adopt standards tailored to local needs. As has been noted, "[p]reemption would restrict the ability of state legislatures knowledgeable about local circumstances to respond to the constantly changing takeover practice." [55]

States also provide the opportunity for experimentation with different regulatory schemes on a smaller scale. Justice Brandeis explained that "[i]t is one of the happy incidents of the federal system that a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." [56] Finally, from a practical standpoint, we do not believe Congress will revisit questions of corporate control every year; future takeover abuses thereby could go unchecked at the federal level.

2. State Regulations Is Not Biased in Favor of Management

In addition to protecting shareholder interests against evolving abuses, states have taken strong steps to curb defenses by corporate management. Existing state laws on fiduciary duty impose obligations on corporate directors, only actions consistent with the directors' fiduciary duties to the shareholders are permissable. Boards of directors bear the burden of showing that a defense mechanism where adopted is based on a reasonable belief "that a danger to the corporate policy existed" and they must satisfy this burden by demonstrating good faith, reasonable investigation, and that the defensive action is "reasonable in relation to the threat posed." [57] This precise judicial approach to defensive tactics is the most efficient mechanism for ensuring proper regulatory control. Indeed, over the last three years, several courts have moved expeditiously to invalidate defensive tactics adopted by boards of directors that are inconsistent with their fiduciary duties to the shareholders.[58]

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[55] Joseph W. Harrison, Testimony Before the House Subcommittee on Telecommunications and Finance, of the House Committee on Energy and Commerce (September 16, 1987).

[56] *New State Ice Co.* v. *Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J. dissenting).

[57] *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

[58] *See, e.g., Ministar Acquiring Corp.* v. *AMF Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985) (poison pill adopted during pendency of tender offer invalidated by injunction); *Edelman* v. *Fruehauf Corp.*, 788 F.2d 882 (6th Cir. 1986) (actions taken by the board held to unreasonably prefer incumbent management); *Hanson Trust PLC* v. *ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986) (board held to not have a blank check to use all possible strategies to forestall acquisition); *Norlin Corp.* v. *Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984) (board's issuance of shares to a wholly-owned subsidiary held to entrench management); *Dynamics Corp. of America* v. *CTS Corp.*, 794 F.2d 250 (7th Cir. 1986) (shareholder rights plan held to be not in best interest of corporation); *Amalgamated Sugar Company* v. *NL Industries*, 644 F. Supp. 1229 (S.D.N.Y. 1986) (discrimination against shareholders was effect of poison pill adopted by directors); *R.D. Smith*

Continued

3. State Regulation Should Not Cause "Balkanization" or Interfere With the National Securities Market

Proponents of federal preemption argue that each state will adopt differing statutes, creating uncertainty, inconsistency, and confusion in our national capital markets, and forcing bidders to comply with fifty inconsistent and overlapping laws. However, as a general matter, there would only be one state law—the law of the state of incorporation—regulating the transaction, just as is the case not for mergers, removal of directors, etc.[59] Even in the few instances where a state law applies to foreign corporations, it usually has a conflict of laws provision deferring to the law of the state of incorporation. In addition, there currently are, and since the early nineteenth century have been, separate state corporate laws regulating everything else relating to corporate governance.

State regulation also will not interfere with the "national securities market." The differences among state corporate laws are not at all troublesome to the market and are far less difficult to evaluate than differences among various articles of incorporation and bylaws, or among classes and types of securities or lines of businesses generally. The market is currently fully able to value securities issued by Indiana companies, Pennsylvania companies or New York companies, despite the fact that the laws regulating contests for corporate control are very different in these states.

With respect to the burdens alleged to be imposed upon interstate commerce, the *CTS* Court expressed little sympathy with the objection that the Indiana Act was somehow interfering with the "market for corporate control." The Court observed that "the commodity that is traded in the 'market for corporate control'—the corporation—is one that owes its existence and attributes to state law." [60] Indiana need not define these commodities as other States do; it need only provide that residents and nonresidents have equal access to them.

4. State Regulation Does Not Preclude Takeovers

As noted above, while the state statute regulating contests for control promote the interests of the constituents of the corporations subject to them and protect shareholders from abusive tender offer tactics, the state statutes are not designed to, nor in fact do, preclude takeovers.

& Company, Inc. v. *Preway, Inc.*, 644 F. Supp. 868 (W.D. Wisc. 1986) (adoption of poison pill discriminated against a large shareholder); *Spinner Corp.* v. *Princeville Development Corp.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,058 (D. Hawaii November 21, 1986), *vacated* [current] Fed. Sec. L. Rep. (CCH) ¶ 93,157 (D. Hawaii January 30, 1987) (poison pill enjoined as discriminating against shareholders); *Buckhorn, Inc.* v. *Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio 1987), *aff'd* 815 F.2d 76 (6th Cir. 1987) (shareholder rights plan enjoined because trigger price held to be too high); *Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985) (directors breached their duty of loyalty to shareholders); *Feinberg* v. *Carter*, 652 F. Supp 1066 (S.D.N.Y. 1987) (directors breached their fiduciary duty to shareholders by failing to show benefit of "greenmail" payment). [New footnote on p. 5].

[59] In fact, in *TLX Acquisition Corp.* v. *Telex Corp.*, a federal district court judge in Oklahoma recently declared the application of Oklahoma's takeover statute to out-of-state corporations to be unconstitutional.* Under the *Telex* decision, there is no danger of overlapping and inconsistent laws because only the state of incorporation will be permitted to regulate. *TLX Acquisition Corp.* v. *Telex Corp.* No. Civ-87-2056-R (W.D. Oklahoma November 3, 1987). [New footnote after added language on p. 1].

[60] 107 S. Ct. at 1652.

While over half of the states have adopted statutes regulating contests for control, tender offers have not been foreclosed. For example, in past months, the following companies were targets of hostile takeover attempts even though they are subject to such statutes: Dayton-Hudson (Minnesota); G. Heileman Brewing (Wisconsin); Golden Nugget (Nevada); Kenner Parker (Massachusetts); Lamaur (Minnesota); Irving Bank (New York); Singer (New Jersey); Dravo (Pennsylvania); DynCorp (Arizona) and Pan Am Corp. (New York).

5. State Regulation Does Not Deny Voting Rights

Opponents of control share acquisition and other state statutes have argued that an acquiror buying a majority of the shares could be deprived of voting rights by the minority.

In theory, this scenario could happen; in practice, it is inconceivable. In fact, in the *CTS* Case, Dynamics Corporation argued, and the Court of Appeals said, that "no rational offeror will purchase shares until it gains assurance that those shares will carry voting rights." [61] Indeed, in practice, an acquiror seeking control would simply condition its tender offer on obtaining full voting rights.

Although some state statutes were adopted quickly in response to a threatened takeover of a company, all of the recently adopted statutes are virtually identical to well-established, well-reviewed, and well-publicized models.

6. State Regulation Should Not Cause Corporations To Race To Find the Most Protective State Statutes

Corporations, with the approval or at the request of their shareholders, might decide to reincorporate in states with laws that provide greater protection to shareholders. But reincorporation is not a management choice: an affirmative shareholder vote taken after adequate proxy disclosure, including discriptions of the relevant takeover laws, is necessary for reincorporation. If shareholders favor reincorporation, it should not be prevented.

7. Federal Preemption of State Laws Would Create Protracted Litigation

If the federal government begins to encroach on the states' role in corporate governance by regulating takeovers, we believe it will become impossible to draw a line as to where the federal regulation ends. States will be ousted from their traditional role in corporate governance, resulting in great uncertainty over just which state corporate laws are preempted. Since there is no federal corporate law, there would be no guidance as to what law to apply. This would likely engender significant and protracted litigation; wide gaps would appear in the governance of corporations.

8. State Regulation Will Not "Tip the Balance" Against the Bidder

The Williams Act, which largely governs the tactics of bidders, has remained unchanged since its enactment twenty years ago. Consequently, bidders have been able to develop and abuse loop-

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[61] *Id.* at 1647.

holes without fear of regulatory action. However, state law which governs management action has been subject to constant review by legislatures, and by the courts under the evolving business judgment rule standard concerning fiduciary duties. We believe that this had resulted in a playing field tilted in favor of the bidder. Accordingly, we believe that state statutes that protect shareholders, and thereby curb some of the abuses, will actually level the playing field and keep the balance in favor of shareholders—not bidders or management.

B. THE FOUR MODEL APPROACHES ADOPTED BY THE STATES AND OTHER STATE LAW PROVISIONS

At present, there are four principal approaches taken by the states in adopting laws to protect shareholder interests in the context of contests for control: (i) control share acquisition laws, (ii) fair price laws, (iii) five-year freeze-out laws, and (iv) control share cash-out laws. The control share acquisition laws protect the majority's interests, while the other three approaches all are concerned with protecting the minority.

All of these laws promote the interests of the constituents of the corporations subject to them—shareholders, employees and other corporate interests—and protect shareholders from abusive tender offer tactics.

1. Control Share Acquistion Laws

Control share acquisition laws are designed to ensure that shareholders acting as a group can make collective decisions regarding a change of control. Without these laws, a change of control could be effected, even against the wishes of a majority of the shareholders, by an acquiror's simple purchase of a controlling block of stock. These laws provide that a majority vote of the shareholders should control the outcome of a decision as important as a change of control.

2. Fair Price Laws

Fair price laws address the narrow problem of "front-end loaded two-tier tender offers." A tactic has been to tender for a controlling block of stock and then threaten to "squeeze-out" in a merger the remaining shareholders at a lower price or for less attractive consideration (such as preferred stock). Shareholders are forced to tender into the offer out of fear that, if they do not, the acquiring person will then force these objecting, nontendering shareholders out of the company at the lower price or for the less desirable form of consideration. The fair price laws require that an acquiring person has to offer the same amount and form of consideration in the merger as they did in acquiring their initial control block.

3. Five-Year Freeze-Out Laws

The five-year, freeze-out fair price laws focus on not only the two-tiered problem addressed by the fair price laws described above, but also various types of "self-dealing" by a controlling shareholder, especially extreme leveraging of the assets of the target company.

These laws address these problems by prohibiting squeeze-out mergers and self-dealing transactions altogether for a five-year period, and permitting them thereafter only if certain conditions are satisfied. These laws directly affect acquirors who finance purchases of a controlling block of stock with debt, and who then intend to merger their acquisition vehicle (which has the obligation to repay the debt) with the target company so that the target company assumes the debt. The target company is then forced to pay off the debt with asset dispositions resulting in layoffs and plant closings. Thus, acquirors can still obtain control over the target corporation and oust management, but they cannot force the target to absorb their acquisition debt.

4. Control Share Cash-Out Laws

Control share cash-out laws serve a different purpose. The cash-out laws operate whenever a person acquires a control block, permitting the minority shareholders to sell their shares in the corporation to the acquiring person at an appraised fair value. Thus, they are intended to ensure that minority shareholders are entitled to receive a fair value for their shares—not just the same value as that received by shareholders who sold originally to the acquiring person—and to ensure that shareholders will receive that value even if the acquiring person does not attempt to squeeze-out the minority. Thus, cash-out laws protect shareholders against self-dealing and front-end loaded two-tier offers.

5. Other Types of State Laws Relating to Contests for Control

The states have also responded to a number of other issues relating to contests for control. For example, a few states have amended their laws specifically to permit consideration of long-term or other corporate interests, not just short-term shareholders interests, as well as employee, community, supplier, and customer interests when taking corporate action. In addition, a few states have adopted provisions banning "greenmail", restricting golden parachutes, and specifically authorizing the board to adopt a shareholder rights plan (a "poison pill"), as long as such plans do not violate the director's fiduciary duties to the shareholders.

C. BACKDOOR PREEMPTION: ONE SHARE/ONE VOTE

At the mark-up of S. 1323, proponents of state preemption offered an amendment to the bill establishing a one share/one vote rule for all public companies. We believe such a proposal would essentially preempt state laws, is antidemocratic, and limits corporate financing methods.

The one-share/one-vote proposal can be seen as a backdoor method of preempting various state laws and most probably an attempt to overturn the recent Supreme Court decision in *CTS*. Justice Powell, writing for the majority in *CTS*, asserted that "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, *including the authority to define the voting rights of shareholders.*" (Emphasis added.)[62] Almost all state corporation laws permit share-

[62] *Id.* at 1649.

holders to adopt capital structures under which some shares or classes of shares, with full disclosure, have greater voting rights than others. Thus, proposals that directly or indirectly forbid any corporation from having shares with different voting rights conflict with almost all state corporation laws, and could prevent corporations from utilizing state laws or accepted corporate measures to protect against abusive takeovers.

For example, the Indiana Act at issue in *CTS* prevents an acquiring person from voting a control block of stock unless disinterested shareholders have granted approval for the voting rights. Because the acquiring person and management are initially disenfranchised, the one-share/one-vote requirement would invalidate the Indiana law and also the fourteen state laws modeled on it. The one-share/one-vote proposals also could be interpreted as preempting statutes such as New York's or Minnesota's that require, at certain times and under certain conditions, approvals of a supermajority of shareholders (*e.g.*, 80 percent shareholder approval) or a majority if disinterested shareholders.

The proposals would also prohibit shareholders from including protective measures in corporate characters such as requirements that certain actions, such as "squeeze-out" mergers, be taken only after approval by a supermajority vote of the shareholders or by a majority of disinterested shareholders. Shareholders' rights plan—so called "poison pills"—would also be placed under a cloud, since these plans protect shareholders by permitting them to acquire shares and, thus, voting rights, on more favorable terms than those available to a raider.

Apart for its intrusion on state law, federal imposition of a one-share/one-vote standard is antidemocratic. It is the shareholders, after full disclosure, who determines voting rights within their corporation. Neither the board of directors nor management can change these rights without shareholder approval. Any legislative or regulatory prohibition of different voting rights adopted by shareholders serves to reduce the say of shareholders. Under a federal one-share/one-vote requirement, even if the majority of all shareholders vote in favor of a capitalizaiton with different voting rights, such capitalization would be prohibited. We believe that it is odd to advocate corporate democracy by denying shareholders the franchise to vote as they wish.

In addition, the one-share/one-vote proposal conflicts with free market principles by restricting innovative capital structures and financing by corporations. Stock with disparate voting rights is a traditional financing tool with many legitimate uses. For example, several corporations adopted creative capital structures to accommodate complex acquisitions– General Motors-EDS and Chemical Bank-Texas Commerce, for example—contrary to a now suspended New York Stock Exchange policy is not shared by other exchanges or the National Association of Securities Dealers ("NASD"). The frequency with which companies use such stock reflects its utility. In addition, certain traditional kinds of securities—preferred stock, convertible debt, shareholder rights plans, etc.--all have the effect of disparately reducing existing voting rights. The ability to issue all these securities benefits the corporation and its shareholders.

A one-share/one-vote requirement also would discourage family-controlled companies from raising capital in the public markets because of the risk of loss of control. Family controlled companies often have a "dual class capitalization" which usually involves two classes of common stock—"A" stock and "B" stock. The A stock is usually held by the public and has one vote for share. Often, the A stock pays a higher dividend than the B stock. This type of capital structure allows a family-owned business to obtain financing through the issuance of common stock without relinquishing control. Some of our most successful corporations have dual class capitalization—The Dow Jones Company, The New York Times Corporation, The Washington Post Company and Wang Laboratories. Investors have not been deterred from investing in these very profitable companies by their dual class structure.

Many proponents of hostile takeovers began to advocate one-share/one-vote proposals only when shareholders of some corporations acting under state law began to adopt voting rights provisions that would make the corporation less vulnerable to a takeover or to manipulative activities.

In addition to dual capitalizations described above, shareholders have used other types of corporate structures with varied voting rights. For example, "capped voting" limits the votes that any one shareholder may cast (without shareholder or other approvals) to a specified percentage of the outstanding shares of common stock—usually 10 percent to 15 percent. Almost identical in purpose and operation to state control share acquisition laws (like Indiana's) capped voting provisions ensure that all shareholders have an effective vote, not just the large shareholder; for example, without capped-voting, minority shareholders are effectively completely disenfranchised once a corporate raider acquires a majority of the voting shares. MCI Corporation and Carter Hawley Hale are two of several companies with capped voting.

"Phased voting rights" permit shareholders who have held their shares for a longer period of time to cast a greater number of votes. This encourages both long term investment in the corporation and a long term management perspective. It does so by permitting management the opportunity to carry out long-range plans without apprehension that raiders will take advantage of short term stock declines due to heavy capital investment, large R&D programs, etc. Cincinnati Milacron and Carlisle Corp. are examples of phased voting.

In sum, we believe that proponents of hostile takeovers may be advocating one-share/one-vote because they do not believe that shareholders should have the right to reduce their company's vulnerability to a takeover. However, this could well result in significant costs: the preemption of the state role, as well as a restriction of shareholder rights and corporate financing flexibility. The proposal on its face suggests that it will insure corporate democracy, but a federal one-share/one-vote requirement is, in our opinion, not a positive step for corporations, shareholder democracy, and the economy.

IV. Conclusion

The economic evidence that we have examined indicates that corporate raiders and their allies have exploited loopholes in the Williams Act to promote their private gain at the expense of the nation's economy, corporations, shareholders, employees, and communities. Their attacks on many of America's leading companies have left the companies severely weakened at a time of rising concern regarding the competitiveness of American business. This bill addresses many of the deficiencies in the Williams Act that raiders have exploited. We support this effort to curb these abuses. We also strongly support the efforts of state governments that have amended their corporation laws to provide shareholders with greater protection against inadequate or coercive tender offers and against abusive defensive practices of management. We write to express our belief that this legislation must be strengthened to reaffirm explicitly the longstanding role of the states in regulating matters of corporate governance.

Jim Sasser.
Terry Sanford.
John Chafee.

ADDITIONAL VIEWS OF SENATORS DODD, CRANSTON, WIRTH, BOND, AND KARNES

We believe amendments to the Williams Act and other provisions of the Federal securities laws are necessary in order to curb certain abusive practices that occur in connection with takeovers, to close certain gaps in the Williams Act, to improve disclosure and ensure adequate time for decision-making in tender offers, and to strengthen the enforcement powers of the Securities and Exchange Commission. Revelations of insider trading, "greenmail" and other unfair and illegal practices have increased dramatically during recent years as the size and numbers of takeovers have risen. These practices, which treat ordinary investors unfairly, threaten to undermine investor confidence in the securities markets. Thus, although we did not support every provision of the bill as reported by the Committee, we strongly support the legislation as a whole.

However, while we believe legislation is necessary to curb certain harmful practices and to address gaps in current law, we do not share what we believe is an overly pessimistic view of takeovers and market professionals reflected in the report accompanying the legislation. Takeovers have been characterized as rewarding short term speculators at the expense of long-term investors, with few benefits for investors, consumers and the economy more broadly. It has been argued that the massive increases in corporate debt, large numbers of employee layoffs and the general decline in competitiveness of U.S. industry in world markets can be attributed in large degree to the current wave of hostile takeovers.

We believe it would be a mistake if the Committee, in making a case for legislation in this area, placed too much emphasis upon the harm caused by takeovers. We do not disagree that hostile takeovers have prompted many changes in industries, in corporate structures and in the manner in which individual companies operate. Nor do we disagree that many of these changes are harmful to individual companies and to the economy as a whole. However, much of the increase in corporate debt, as well as the larger share of employee layoffs, has come about through friendly mergers and divestitures, management leveraged buyouts and corporate restructurings prompted by conditions in declining industries, the deregulation of still other industries, heightened competition in world markets, incentives provided in our tax structure favoring debt over equity, and numerous economic and other factors, as well as the threat of hostile takeovers. Simply stopping or discouraging hostile takeovers may not be a solution to these broader concerns.

Moreover, we believe it is important to acknowledge that there are studies and reports of the benefits derived from takeovers, ranging from providing large increases in wealth for shareholders (millions of whom are long-term shareholders and not merely short-term speculators); prompting industries to meet economic

changes more rapidly; and shaking up "sleepy" management in some cases (although it is clear that hostile takeovers are launched against well-managed companies as well as those in which management's performance can be faulted for a low stock price; the "lax management" theory is greatly overblown.) After much review of this area, we are convinced that the gains from takeovers are not simply found in the imagination of Chicago-school, efficient market believers, but they are propounded even by those managements who are "shaken up" by corporate raiders, as managements of Disney and other companies have said after-the-fact.

Thus, while we do not argue with the conclusion that legislation is necessary to correct abusive practices and gaps in current law and to moderate the pace of corporate takeovers, we believe the Committee and the Congress should take a balanced view of the economic consequences of hostile takeovers.

At the same time, we believe the increased incidences of illegal activity in connection with takeovers present a serious threat to the integrity of our capital markets. Insider trading, parking, illegal group activity, and false and misleading disclosures in connection with corporate control contests, are all illegal under current law. These illegal practices require increased vigilance by the SEC, as well as steps by Congress to strengthen the enforcement tools of the SEC and Department of Justice to provide added deterrence. In this respect, the legislation provides increased penalties for insider trading, perjury and obstruction of justice in connection with insider trading cases. In addition, the legislation gives the SEC rulemaking authority to require additional steps by securities firms to control the illegal use of inside information. We believe these measures are critical and should receive broad support, regardless of one's views of the benefits or harm from takeover activity generally.

However, while we strongly support these provisions in the legislation, we believe it would be a mistake for the Committee to send the message that takeovers are harmful *because* these illegal activities occur *in connection with* takeovers and that takeovers are replete with illegal activities by unscrupulous operators. No one would argue that takeovers provide tremendous incentives for insider trading and fraudulent activity. Recent cases against a number of securities professionals reveal a shocking indifference by those individuals to their responsibilities to treat investors fairly and maintain the integrity of our vital capital markets. However, we believe that takeovers have a place in our economy, and the vast majority of market participants abide by the law. Legislation should be targeted to deter and punish unscrupulous traders and market participants, rather than to curb takeovers more broadly in an attempt to limit the opportunities for fraud and abuse. To a large extent, we believe the legislation meets this objective.

We wish to provide specific, additional views in the three areas where the Committee voted to omit certain provisions from the reported bill. Those were the decision to eliminate from the legislation a provision expressly affirming the rights of states to adopt certain laws, the decision to eliminate prohibitions against the adoption of "poison pills" and "golden parachutes" during a takeover, and the decision to reject amendments codifying a "one

share/one vote" rule for certain public companies. In these areas, while we support the result, we believe additional views are necessary in order to reflect all of the considerations that were part of the decision-making process.

STATE LAW

There is no question that, historically, states have regulated the internal affairs of corporations, and federal law has been focused primarily upon disclosure to shareholders and the fairness of the national trading markets. However, corporate takeovers present unique situations where traditional notions of what may be internal corporate governance and the regulation of trading in national markets often are blurred. Moreover, recent state takeover laws have attempted to meet Constitutional challenges to state regulation of takeovers by characterizing the legislation as affecting internal corporate governance, and not takeover bids. Nonetheless, it is clear that such legislation affects both the conduct and outcome of takeover contests.

We do not believe it is as important to write laws in such a way as to fit historical theory, as much as it is critical to examine just what policy objectives are being sought in federal and state regulation, and how the various laws affect these policy objectives. It may be that some state laws, regardless of whether they meet the "internal affairs" doctrine, will unduly restrict takeovers and the free transferability of shares in the national market, and Congress may determine to preempt such laws. On the other hand, state laws expressly regulating takeover bids may provide benefits for shareholders in the national market and for corporations generally, and Congress may determine that such laws serve the national interests.

It is our view that state takeover laws adopted subsequent to the Supreme Court's *CTS* decision are too new—and the experience under them is too limited—to adequately assess what the impact of these laws may be on takeovers and on shareholders.

Thus, we concur in the decision to neither preempt nor affirm state laws in the legislation, but to maintain the status quo while the GAO studies the impact of these laws. However, while this decision reflects continued support for state regulation in this area, we are concerned about overreaching by states and believe this area warrants continued Congressional review. We are also concerned about the manner in which many state takeover laws are adopted, often in the midst of a specific takeover battle. It is our hope that members of state legislatures will work to develop responsible laws in this area.

MANAGEMENT DEFENSIVE TACTICS

The legislation as introduced prohibited the adoption of "poison pills" and "golden parachutes" during a takeover. It was our view that these provisions were flawed in a number of respects, and we therefore supported an amendment to strike them.

To begin, prohibiting these devices during a takeover, but permitting them if adopted prior to a takeover, might be perceived as the Committee's approval of the hundreds of such devices already

adopted by major corporations. If these devices are believed harmful, a total prohibition would be more appropriate.

In addition, defensive tactics other than golden parachutes and poison pills under certain circumstances may be just as harmful to shareholders but would not be covered by the legislation. These include "lock-up options," the defensive issuance or repurchase of shares to thwart a takeover, and numerous others. To prohibit some, but not all, defensive tactics might be perceived as indicating Congressional approval of these other devices. Moreover, managements determined to thwart a hostile bid would inevitably turn to defensive actions not prohibited by the legislation.

We believe, as the majority report reflects, that state courts, and federal courts applying state law, are attempting to address abusive defensive practices adopted by management in efforts to thwart takeovers. Following the *Unocal* decision in 1985, many courts have held managements and boards of directors to a higher standard under the business judgment rule in change of control cases. We believe this is appropriate, given the potentially conflicting interests weighing upon even the most scrupulous managements and boards when confronted with change of control issues.

Moreover, we believe, given the changing nature of takeovers and takeover defenses, it is appropriate to permit courts to address the propriety of defensive actions on a case-by-case basis. A poison pill or lock-up option may be appropriate and beneficial to shareholders in one case, buy damaging in another. Thus, we believed it was appropriate to stike prohibitions on specific defensive tactics from the bill and leave these matters to courts to resolve on a case-by-case basis. However, as in the area of state takeover laws, we believe this area merits continued monitoring by the Congress and the SEC.

ONE SHARE/ONE VOTE

As indicated in the report accompanying the legislation, the Committee voted against amendments to codify a one-share/one vote standard for certain public companies. We believe this appropriate, in view of the fact that the SEC is currently undertaking a rulemaking proceeding and reviewing extensive comments in this area.

While some have argued that corporate capitalizations should remain solely in the realm of state law, it should be stressed that these matters have been addressed at the national level for more than 60 years in the rules of the self-regulatory organizations, primarily the New York Stock Exchange. In view of heightened competition among the exchanges and the NASDAQ system, the ability of the New York Stock Exchange to maintain its one share-one vote standard has been threatened in recent years.

We believe there may be a place for a "federal floor" on shareholder voting rights, and that the SEC may determine to require that the self-regulatory organizations adopt similar voting standards requirements for public companies of certain sizes. However, in view of the SEC's ongoing proceedings, a codification of such a standard in federal law in unwarranted at this time, especially as the agency approaches completion of the issue and the rulemaking

process. The failure to adopt amendments to require such a standard should not be viewed as opposition to the SEC's action in this area. Instead, it should be viewed as a decision to delay action until the implications of such action are fully debated at the SEC and reviewed by the Congress as provided in the legislation.

CHRIS DODD.
ALAN CRANSTON.
TIM WIRTH.
KIT BOND.
DAVID K. KARNES.

SUPPLEMENTAL AND ADDITIONAL VIEWS OF SENATOR SHELBY

The tender offer reform legislation passed by the Senate Banking Committee has made several constructive and needed changes to our nation's securities laws: closure of the Section 13(d) 10-day window; extension of the minimum number of days provided to share holders for review of tender offers; elimination of the "creeping" tender offer; access to the proxy machinery for minority shareholders; increased penalties for inside trading; and increased disclosure requirements applicable to purchasers of 5 percent of a company's stock. These specific reforms further the original objective of the Williams Act by providing a fair balance between the competing interests in contests for corporate control. The Committee wisely avoided pursuing broad, unnecessary measures such as limitations on acquisition financing

I do not agree, however, with the Committee's decisions regarding a fundamental issue of corporate governance: shareholder's rights. Provisions are necessary to preserve the integrity of the shareholder franchise. The Committee should have considered and adopted measures designed to fill this void. I suggest that specific provisions mandating a one-share/one-vote standard and requiring confidential proxy voting, if incorporated in the legislation, would provide the shareholder the safeguards now lacking.

As a general rule, owners of common stock should be entitled to a vote that gives them an effective voice in governing the enterprise in which they hold an economic interest. I believe as strongly in corporate democracy as I do in our representative democracy.

Rather than include a one-share/one-vote standard, the Committee lamely requested another study by the Securities and Exchange Commission (SEC). During the past several years, numerous studies were completed on the one-share/one vote issue which revealed that the creation of disparate voting rights plans has had a negative effect on management accountability and shareholders' rights. I am uncertain that another study which would show that disparate voting rights plans enable a realtively small group of individuals to obtain and control a corporation, while further distancing management from the shareholders, would prove to be anything other than dilatory. If insulated from mechanisms which foster accountability such as proxy controls and tender offers, management is free to act as it pleases, even if not in the interests of the shareholders.

The concept of one-share/one-vote has for more than 60 years been the standard of the securities industry. The SEC has already conducted lengthy public hearings and developed an extensive record on a proposed rule to mandate a one-share/one vote standard. Congress has held hearings on the one-share/one vote issue in both Sessions of the 99th Congress and this year in the 100th Con-

gress. The one-share/one-vote concept has been so thoroughly researched and reported that further study would be redundant.

The Committee should have included a provision generally requiring one vote for each share of common stock. An exception to the general rule to grandfather companies which have already adopted disparate voting rights plans, especially those in which greater voting rights are based on length of continuous beneficial ownership, could be provided for in the statute. Further, grandfathered companies could be permitted to issue additional shares of existing classes of stock. Other appropriate exceptions to the general rule such as for a modified voting structure for family run companies could also be included in the statute. The SEC should be given delegated authority to implement and interpret the statute by rulemaking.

As reported out of Committee, the legislation also lacks a provision guaranteeing the confidentiality of the voting process. Confidential voting protects the privacy of shareholders so that they can exercise their decision making power free of management coercion. Currently, management knows the outcome of shareholder balloting before a vote is tallied. This is unfair and should be changed.

Though the Committee did adopt an amendment to provide access to the proxy mechanisms for shareholder's owning 10 percent or more of a company's stock, the bill does not go far enough to protect the voting confidentiality of all shareholders. Failure to enact provisions to ensure the confidentiality of the proxy system for all shareholders results in protecting entrenched management. Shareholders are frozen out of the system by which corporate control is obtained and exercised.

The Committee's bill goes a long way toward correcting many of the shortcomings in the area of corporate governance and control. However, more protection is required for the shareholder. The Senate should amend the legislation when it comes to the floor for consideration to include both a one-share/one-vote and a confidential proxy voting provision.

RICHARD SHELBY.

ADDITIONAL VIEWS OF SENATOR GARN

S. 1323, the "Tender Offer Disclosure and Fairness Act of 1987," seeks to address certain alleged abuses arising from the recent increase in hostile corporate takeovers. The bill raises thorny issues concerning the sometimes competing interests of corporate managers and shareholders. The bill also raises difficult issues arising from the occasional conflict between the long-recognized right of the states to regulate the governance of corporations they charter and the equally well-recognized responsibility of the federal government to maintain the free flow of interstate commerce and national securities markets. Unfortunately, the bill's responses to these issues are both inappropriate and inadequate.

As is evidenced by the Committee Report, this bill's problems arise from its being based on a far too one-sided approach to the issues raised by corporate takeovers. The Report reflects an unbalanced focus on only the alleged abuses and negative economic consequences associated with a small minority of takeovers. Missing from the Report is a balanced discussion of the benefits to stockholders and to the economy as a whole that arise from the majority of corporate takeovers.

In enacting the Williams Act in 1968 to regulate corporate takeovers, Congress clearly intended to strike a delicate balance between competing concerns. The purpose was to provide more disclosure and create a more level playing field for takeovers, while at the same time minimizing the conflict between management and shareholders and between state corporate governance laws and federal securities laws.

Over the years there have been abuses by both managers and so-called "raiders." Corporate managers, in order to protect their positions, have engaged in such abusive practices as the establishment of "poison pills" and "golden parachutes." Likewise, corporate raiders have at times made millions of dollars without ever doing anything to improve the management of a target company. And both sides have colluded in the payment of "greenmail" at the expense of other shareholders.

The problem with this legislation is that it goes too far in trying to protect the interests of corporate management (including their abusive practices), while doing too little to protect the legitimate rights of sharholders to have management accountable to them. Virtually all of the bill's provisions are aimed at impeding corporate takeover activity. The bill fails to address the most abusive practices of corporate managers in protecting their turf. For example, the bill imposes an unworkable scheme for requiring investors to declare their "intent" in buying certain amounts of stock, but it is absolutely silent about "golden parachutes" and "poison pills."

The bill is also silent about the increasing encroachment of state legislatures into the area of regulating and preventing takeovers.

The Supreme Court recently upheld the states' authority to expand their corporate governance laws to reach areas traditionally governed by the federal tender offer statutes. *CTS Corp.* v. *Dynamics Corp.*, 107 S.Ct. 1637 (1987). This has spawned a spate of restrictive state statutes, some of which simply go too far in the direction of denying shareholders their legitimate rights. That is why I supported the very limited amendment offered at the Committee mark-up that would have had the effect of overriding certain overly restrictive state laws.

This is not something I did lightly. There is not another member of this body who takes the issue of states rights more seriously than I do, as my record shows. But some aspects of the national economy simply require federal standards under long-recognized principles. An analogy can be drawn with the need for a single currency standard: the nation's economy simply could not tolerate 50 different kinds of currency. This does not mean I would support efforts to take traditional corporate governance authority away from the states. I opposed the one share-one vote amendment because its effect would be to do just that. But certain state laws, as I mentioned, have gone too far.

In short, S. 1323 is based on an unbalanced approach to the issues raised by corporate takeover activity, and as a result, the bill's proposed responses to these issues are inappropriate and inadequate. I will support efforts to improve the bill at later stages in the legislative process.

JAKE GARN.

ADDITIONAL VIEWS OF SENATOR ALFONSE M. D'AMATO

The Views which follow are not intended to be a general indictment of the concept of takeover reform or a specific denunciation of S. 1323, The Tender Offer Fairness and Disclosure Act of 1987 (hereinafter referred to as S. 1323). Rather, these views are designed to demonstrate specific deficiencies in the legislation as currently drafted and to offer recommendations designed to improve S. 1323. (My belief that the Williams Act is in need of amending is represented by the takeover reform packages, that I introduced in both the 99th (S. 1907) and the 100th (S. 227) Congress.)

Part I of the Views provides both the casual observer and the close student of the takeover phenomena with empirical evidence and other arguments that were either overlooked or ignored during the consideration of S. 1323 by the Senate Committee on Banking, Housing and Urban Affairs ("Committee"). The empirical evidence and the arguments contained in Part I of the Views explains our opposition to S. 1323 as reported by the Committee on September 30, 1987.

As Part I will demonstrate, the extensive empirical literature on mergers, tender offers, and other corporate control transactions has yielded several important conclusions. Corporate acquisitions, including leveraged buyouts, create enormous value for target shareholders. Shareholders of acquiring firms may also benefit from these transactions, although to a far lesser degree than target shareholders (partly because of the larger size of acquiring relative to acquired firms). Modern-day corporate restructurings also have created value for target shareholders that may be comparable to that obtained by corporate combinations. In sharp contrast, target companies that defeat hostile takeover bids by legal challenge almost invariably impose large capital losses on their shareholders.

Par III of the Views offers an explanation of several amendments which were either narrowly defeated in the Committee or defeated by a tie vote (10–10). Several of these amendments will be introduced and debated at length during the Senate's consideration of S. 1323. The inclusion of these amendments is necessary to correct many of the existing inequities contained in S. 1323 which discriminate against shareholders to the benefit of corporate management.

Part III of the Views offers an explanation of certain deficiencies in S. 1323. Part III identifies and describes why these provisions are either unwise, unnecessary or unworkable and therefore inconsistent with the purposes and intent of the Williams Act and the federal securities laws.

PART I

A. INTRODUCTION

In recent years, contests for corporate control have been conducted with the intensity of military campaigns, with the futures of large and small companies and the economies of affected communities hanging in the balance. Elaborate strategies and ingenious tactics have been, and continue to be, developed to facilitate takeover attempts and to defend against them. Skirmishes are fought in company boardrooms, in shareholders' meeting and, often, in the courts.

Although mergers and acquisitions are not a new phenomena, multi-billion dollar contests for corporate control have only recently become regular occurrences on the American business scene. Once the private domain of a handful of commercial and investment bankers, lawyers, institutional investors, arbitrageurs, and corporate executives, control contests have become an increasingly popular spectator sport. The increased amount of corporate takeover activity in recent years has also come to the attention of Congress.

Unfortunately, the debate over corporate takeovers which has occurred in the media and in Congress is often dominated by hype and myth. The Report accompanying S. 1323, The Tender Offer Disclosure and Fairness Act of 1987 (hereinafter referred to as the Report) which precedes these Views only perpetuates many of these exaggerations and myths and adds little to the substantive debate on the benefits and shortcomings of corporate takeovers.

The hype, hysteria, and disinformation campaign aimed at corporate takeovers resulted in the introduction and passage of S. 1323 by the Committee. The introductory statements of the bill's sponsors leaves no doubt that S. 1323 is specifically intended to thwart takeover activity. Before the Senate enacts legislation designed to thwart takeovers, Senators must look beyond the myth to the economic realities of corporate takeovers. A careful examination regarding crucial policy questions must be addressed and answered before anti-takeover legislation is adopted. These questions include: (1) Is corporate efficiency improved by mergers and acquisitions?; (2) Do shareholders benefit from contests for corporate control?; (3) Does the economy as a whole benefit from takeover activity?; and (4) Who are the principle proponents of anti-takeover legislation and why are they so vehement in their opposition to hostile takeovers?

The answers to these four questions are clear: an active market for corporate control improves corporate efficiency and benefits shareholders and the economy at large. Equally clear is the fact that the proponents of anti-takeover legislation at the state and federal level are the corporate executives whose jobs are threatened by takeover activity. The answers to these questions are substantiated by empirical evidence, which is in sharp contrast to the "evidence" found in the Report. The "evidence" contained in the Report to "justify" the need for S. 1323 amounts to nothing more than a compendium of anecdotes. Public policy is not best served by reliance upon unsubstantiated claims.

When evaluating S. 1323, takeover activity must be put in proper perspective. Takeovers are simply a device that transfers control of assets from one group of managers to another. The takeover mechanism unambiguously protects shareholder interests, since the possibility of a takeover is a constant reminder to managers that their job is to maximize shareholder value since the shareholders, not corporate executives, own the corporation. Moreover, takeovers are only accomplished with the consent of affected shareholders who derive large benefits from these changes in control.

B. S. 1323 CONTRAVENES THE ORIGINAL INTENT OF THE WILLIAMS ACT

The cumulative effect of the provisions of S. 1323 will be to curb all takeover activity. The legislation does not distinguish between hostile and friendly takeovers. However, if S. 1323 managed to make such a distinction, it would still be in direct contravention of the legislative intent of the Williams Act. In 1968, Congress enacted the Williams Act to provide a framework for the regulation of corporate takeovers in the national marketplace. The Williams Act was designed to fill a gap in the federal securities laws to ensure that investors and target companies had adequate information and opportunity to make investment decisions in transactions designed to cause, or prevent, a substantial shift of ownership or control. The Williams Act was not intended to discourage or encourage takeover activity or to provide management or any other group with special privileges or advantages over another. The Williams Act sought (i) to avoid tipping the scales either in favor of management or in favor of the bidder; (ii) to require full and fair disclosure to shareholders; and (iii) to provide the bidder a fair opportunity to make, and management a fair opportunity to oppose a tender offer.[1] S. 1323 strays too far from these principles and instead reflects unsubstantiated normative judgments concerning the appropriateness of takeover bids and management defenses.

By choosing a "neutral" regulatory scheme with the adoption of the Williams Act in 1968, Congress acknowledged that hostile tender offers provide potential benefits to shareholders and to the economy as a whole.[2] Its goal was to ensure that shareholders had a fair opportunity to accept or reject a takeover bid. In the report accompanying the Williams Act, its authors noted:

> The Committee has taken extreme care to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. The bill is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case.[3]

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[1] The Williams Act, enacted in 1968 and amended in 1970, added Sections 13(d), 13(e), 14(d), 14(e) and 14(f) to the Securities Exchange Act. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454; Act of Dec. 22, 1970, Pub. L. No. 91-567, 84th Stat. 1497 (codified at 15 U.S.C. 78m(d)-(e) and 78n(d)-(f) (1970)); 113 Cong. Rec. 854 (1967); *See generally* S. Rep. No. 550, 90th Cong., 1st Sess. 2 (1967) (Senate Report); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 2 (1968) (House Report).

See also Senate Report at 2-4; House Report at 2-4; 1968 U.S. Code Cong. & Ad. News, 2811, 114 Cong. Rec. 21483-84 (July 15, 19068) (Comments of Representative Springer and Whalen); 113 Cong. Rec. 854-55 (1967) (Comments of Senator Williams); 113 Cong. Rec. 24664 (1967) (Comments of Senator Williams); *id.* (Comments of Senator Javits).

[2] *See*, S. Rept. 99-550, 90th Cong. 1st Sess. The Williams Act is found in Sections 13(d) and (e) and 14(d)-(f) of the Exchange Act, 14 U.S.C. Sections 78m(d) and (e) and 78n(d)-(f).

[3] *Id.* at 3.

Thus, the Williams Act, passed as amendments to the Securities Exchange Act of 1934 ("Exchange Act"), has as its purpose the protection of shareholders—primarily the shareholders of the target company in a tender offer—rather than target managers. That protection is achieved in a manner consistent with the underlying philosophy of the federal securities laws,—full and fair disclosure. For example, the Williams Act requires that any person acquiring five percent or more of an issuer's securities must notify the issuer and file a disclosure statement with the Securities and Exchange Commission ("SEC" or "Commission").[4] It requires further that certain facts be disclosed in materials sent to shareholders subject to a tender offer.[5] By contrast, the proponents of S. 1323 would consciously seek to aid target managers in their efforts to prevent shareholders from making the ultimate decision to accept or reject a takeover bid.

The Williams Act also contains a number of substantive requirements that go beyond pure disclosure. For example, it requires that if more shares are tendered than the number requested, each shareholder is entitled to have shares accepted on a pro rata basis.[6] It also requires that any shareholder tendering shares be permitted to withdraw those shares for a specified period of time.[7] These provisions ensure that shareholders will have adequate time and an unpressured environment in which to make decisions, taking into account the information required to be disclosed under the Exchange Act.

The Williams Act also governs certain activity by target management with respect to a tender offer. For example, rules promulgated under the Act require that the target company disclose, within 10 days after the announcement of a third party bid, whether it recommends that shareholders accept or reject the tender offer.[8] Moreover, the Act also regulates tender offers and stock repurchases by the target itself, including offers and purchases made in response to third party tender offers.[9]

Finally, the Williams Act contains a tender offer antifraud provision, modeled after other provisions in the securities laws, prohibiting "manipulative, deceptive and fraudulent acts or practices" in connection with a tender offer.[10] The SEC has used its rulemaking authority under this and other provisions to promulgate additional substantive rules.

Thus, passage of the Williams Act established a federal policy of neutrality, with respect to takeover contests, and continued a federal disclosure and shareholder protection policy in existence since the adoption of the 1933 and 1934 securities laws. The Williams Act is not directed to protecting the corporate enterprise itself, nor to regulating the "governance" of corporations, except in limited areas. These matters are understood to be in the province of state

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[4] Section 13(d) of the Exchange Act.
[5] Section 14(d)(1) of the Exchange Act.
[6] Section 14(d)(7) of the Exchange Act.
[7] Section 14(d)(5) of the Exchange Act. This protection has been extended further by Rule 14d-7, which permits shareholders to withdraw tendered shares at anytime during a tender offer.
[8] Rule 14e-2.
[9] Section 13(e) of the Exchange Act.
[10] Section 14(e) of the Exchange Act.

corporate law. State law, moreover, did not significantly restrict the free transfer of stock from one shareholder who wished to sell to another who wished to buy. In its present form, S. 1323 abandons the federal policy of neutrality with regard to tender offers. Further, in an environment where states are now aggressively trying to protect their own narrow and parochial interests, S. 1323 is silent on the federal vis-a-vis the state role in the regulation of takeovers.

The need for the market discipline imposed upon corporate managers by the potential of a tender offer is further necessitated because the federal securities laws are not designed to provide significant checks on the autonomy of corporate managers. The federal securities laws are and should be primarily directed at ensuring full disclosure and other protections for shareholders but not for directly intruding into state regulation of corporate governance. While a law professor at Yale, William O. Douglas (who later became Chairman of the Securities and Exchange Commission before becoming a Justice of the Supreme Court), expressed concern over the absence of provisions in the newly enacted federal securities laws that would provide greater shareholder control over the corporation. Justice Douglas argued:

> * * * [T]here is nothing in the Act [referring to The Securities Act of 1933] which controls the power of the self-perpetuating management group which has risen to a position of dominance in our industrial organization. There is nothing in The Act which purports to deal with the protection of the rights of shareholders.[11]

By further entrenching management in its position of dominance, the provisions of S. 1323 will only heighten rather than relieve the concerns expressed by Justice Douglas. This furtherance of management's autonomy by provisions which severely impede takeover activity is accomplished at the expense of shareholders. S. 1323 significantly reduces the effectiveness of takeovers as a discipline imposed upon corporate managers without providing adequate substitutes which give shareholders a reasonable measure of control over corporate conduct.

C. THE PROPONENTS OF ANTI-TAKEOVER LEGISLATION

The most vocal participants in the debate regarding increased regulation of contests for corporate control have been the chief executive officers of many of America's largest corporations. The corporate witnesses which appeared before the Committee in support of S. 1323, their annual incomes and the value of their corporate shareholdings (as of December 8, 1987) follows:

(1) H. Brewster Atwater Jr., General Mills, $1,164,000.00 salary, owns 95,000 shares valued at $4,251,250.00;

(2) Donald C. Clark, Household International, $1,111,000.00 salary, owns 14,000 shares valued at $467,250;

(3) David M. Roderick, USX, $735,000.00 salary, owns 7,000 shares valued at $204,750;

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[11] Cited in J. Seligman, *The Transformation of Wall Street* (Boston: Houghton Mifflin, 1982) pp. 71–72.

(4) George S. Slocum, Transco Energy, $384,000.00 salary, owns 15,000 shares valued at $330,000;

(5) Andrew C. Sigler, Champion Intl., $860,000.00 salary, owns 9,000 shares valued at $281,250;

(6) James K. Baker, Arvin Industries, $432,000.00 salary, owns 32,000 shares valued at $476,000;

(7) Thomas F. Frist, Jr., Hospital Corp. of America, $300,000.00 salary, owns 443,000 shares valued at $13,400,750;

(8) William R. Howell, J.C. Penney, $914,000.00 salary, owns 14,000 shares valued at $607,250;

(9) Robert P. Luciano, Schering-Plough, $908,000.00 salary, owns 37,000 shares valued at $1,720,500;

(10) Robert E. Mercer, Goodyear Tire & Rubber, $557,000.00 salary, owns 3,000 shares valued at $155,250;

(11) William D. Smithburg, Quaker Oats, $872,000.00 salary, owns 157,000 shares valued at $6,672,500; and

(12) Alvah H. Chapman, Knight-Ridder, $671,000.00 salary, owns 200,000 shares valued at $7,750,000.[12]

These spokesmen for the big companies do not object to all corporate takeovers and restructurings. Many run companies that have been and continue to be active in the takeover market. Rather their objection is more narrow: they want to prevent takeovers that threaten their own jobs.

For example, Andrew Sigler, chief executive officer of Champion International and chairman of the Business Roundtable, has been a vocal opponent of corporate raiders and what he calls the "bust-up takeover frenzy." [13] Yet Champion's own "white knight" takeover of St. Regis Corp. in 1984 was followed within a year by nine separate divestitures and three plant closing and layoff announcements, as reported in the Wall Street Journal. No doubt these steps were necessary to improve the efficiency of the merged companies, and the closings and layoffs may have occurred anyway. Yet, for other similar companies that have been unwilling to complete necessary restructurings on their own, Sigler would have the federal government prevent a hostile bidder from coming in and completing the task. Efficiency gains for the U.S. economy thus would take a back seat to preserving the jobs and perquisites of poor managers.

These business executives, their lobbyists and their representative trade associations have trained their guns on what they claim to be the single greatest threat to the American economy and the corporate culture to which they have grown accustomed—the corporate raider. A few of these titans of industry have recently spent as much time in the halls of Congress and in Congressional hearing rooms as they have in their boardrooms. Their energies have been expended in an attempt to rid the economy of the pox of the corporate raider. Thus, it is especially ironic that the most vehement critics of takeovers, the chief executive officers of the companies that appeared before the Committee, have engaged in a consider-

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[12] *See*, "The Corporate Elite: Chief Executives of the Business Week Top 1000," *Business Week*, October 23, 1987.

[13] Sigler, *Looking Beyond the "Aw-Shucks" Act*, N.Y. Times, March 1, 1987, §3, at 2 col. 3.

able amount of takeover or merger and acquisition activity in recent years.[14]

The leaders of corporate America have engaged in a two-pronged assault to rid the economic landscape of hostile corporate takeovers. The battleground of this war on takeovers not approved by the target's board of directors has occurred not only in the halls of Congress, but also in state legislatures, where the corporate lobby has achieved phenomenal success in the enactment of state anti-takeover laws.[15] Several commentators have raised concerns that local political and economic interests may dominate a state's approach to corporate governance.[16]

At present, 31 states have enacted anti-takeover laws. This number will undoubtedly increase due to the decision of the United States Supreme Court in *CTS Corporation* v. *Dynamics Corporation of America.* In the *CTS* decision the Supreme Court upheld the constitutionality of the Indiana anti-takeover law.[17]

The business community has not limited its quest for life tenure in state legislatures to the enactment of anti-takeover statutes.

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[14] *See* S. Hrg. 100-50, Hostile Takeovers, Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. (January 28, March 4, and April 8, 1987) (hereinafter cited as Hostile Takeover Hearings) at pp. 125-128.

[15] Currently, four types of state anti-takeover statutes have been adopted. These include the control share acquisition type state, the five year freeze out type statute, the fair price type statute, and the control share cash out type statute.

The following states have adopted control share acquisition statutes: Arizona, Florida, Hawaii, Indiana, Louisiana, Massachusetts, Minnesota, Missouri, Ohio and Wisconsin.

The following states have adopted five year free out statutes: Florida, Indiana, Kentucky, Minnesota, Missouri, New Jersey, New York and Washington.

The following states have adopted fair price laws: Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Michigan, Mississippi, North Carolina, Virginia and Wisconsin.

The following states have adopted control share cash out laws: Pennsylvania, Maine and Utah.

[16] *See* Macey & Miller, *Toward an Interest Group Theory of Delaware Corporation Law,* 65 Tex. L. Rev. 469 (1987); Romano, *The Political Economy of Takeover Statutes,* 73 Va. L. Rev. 111 (1987); Romano, *The State Competition Debate in Corporate Law,* 8 Cardozo L. Rev. 709 (1987).

[17] 107 S. Ct. 1637 (Apr. 21, 1987).

The Supreme Court's decision to uphold Indiana's control share acquisition statute should provide neither legislators or corporate executives with great comfort. Neither should the decision be viewed as a politically expedient solution to the quagmire of tender offer reform proposals. The problems in upholding the Indiana statute were articulated by Justice Scalia in a separate opinion. Justice Scalia observed: "I do not share the Court's apparent high estimation of the state statute at issue here. But a law can be both economic folly and constitutional."

During consideration of S. 1323, an amendment was offered and defeated to minimize the impact of the Indiana statute on those shareholders effectively disenfranchised by the Indiana law. Critics of this amendment incorrectly argued that it constituted a federal pre-emption of state law. Those who contend that a federal preemption of state laws in this area is the first step to the federalization of corporate law fail to recognize that certain state anti-takeover laws essentially pre-empt the rights of shareholders. The passage of these state anti-takeover laws have been hurried affairs usually done at the behest of one corporation in the state. The laws apply to all shareholders of every company coming within the statutes jurisdiction. There is no evidence that these shareholders sought or desired such "protections" which often result in the decreased value of these shareholdings. Since the securities markets in this country are national and becoming increasingly international, the federal government has a role in protecting the rights of shareholder from discriminatory treatment through the operation of state laws. Tender offer reform that is truly in the shareholders interest will invalidate those state laws which: preempt the rights of all shareholders without their approval by denying them their voting rights; attempt to regulate companies incorporated in other states; prohibit the exercise of other ordinary rights of shareholders; and deny equal treatment of shareholder.

Studies which have examined the impact of these state anti-takeover laws have concluded that they have an adverse impact on shareholders. For example, the SEC's office of Chief Economist examined the effects on shareholders of an Ohio anti-takeover statute, similar to Indiana's that was signed into law in November 1986. The SEC study concluded that such laws are probably not in the best interests of shareholders because the stock prices of the 37 companies headquartered in Ohio experienced a net market decrease of 2 percent by the following May. A Federal Trade Commission study of the effects of the New York anti-takeover law also found a negative effect on shareholders.

Since the Delaware Supreme Court decision in *Smith* v. *Gorkom*,[18] corporate America has been successful in persuading state legislatures to enact laws to shield corporate directors from liability for violations of the fiduciary duty of care.[19]

One argument frequently cited by the business community to support its claim that the courts are protecting shareholders in contests for corporate control is that the business judgment rule is no longer being interpreted to shield the actions of incumbent managers in thwarting takeovers. It is true that some courts have been moving away from essentially granting incumbent managements an almost absolute immunity for their conduct in contests for corporate control where they seek the safe harbor of the business judgment rule.[20]

However, in response to *Van Gorkom* and the rising cost and dwindling availability of liability insurance to officers and directors, corporate America sought and obtained in the Delaware corporation laws a provision that limits or eliminates directors' liability for the breach of the fiduciary duty of care.[21] The fiduciary duty of care is breached by acts of gross negligence such as the court found to have occurred in *Van Gorkom*. This law permits a corporation, by shareholder vote, to amend its certificate of incorporation to limit or eliminate directors' liability for breach of the fiduciary duty of care.

Following Delaware's lead, 17 other states have enacted laws designed to limit or eliminate the civil money liabilities that may be imposed upon officers and directors for breaching the fiduciary duty of care. These states include: Idaho, Iowa, Kansas, Massachusetts, Mississippi, Minnesota, Nevada, New Jersey, New Mexico, Oregon, Pennsylvania, South Dakota, Utah, Virginia, Washington and Wyoming.

Similar legislation is pending in California, Colorado, Connecticut, Florida, Georgia, Illinois, Maine, Missouri, Nebraska, New York, North Carolina, Oklahoma, Tennessee, Texas and West Virginia.

The second front of the business lobby's attack on corporate takeovers is positioned in the halls of Congress. In hearing after hear-

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[18] 488 A.2d 858 (Del. 1985).

[19] For a detailed examination of an impact of such state laws, see Linsley, Statutory Limitations on Director's Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule, 24 *Harv. Journal on Legis.* 528 (1987).

[20] Judicial scrutiny has largely been reserved, however, for cases where a target's board of directors deliberately distorts the playing field to favor a leveraged buyout by management over a competing bid by a third party. *See, e.g., Hanson Trust PLC* v. *SCM*, 774 F.2d 47 (2d Cir. 1985); *Revlon, Inc.* v. *MacAndrews & Forbes Holdings*, 506 A.2d 173 (1986). The business judgment rule is alive and well as a defense in most other cases. If anything, Delaware and other states have expanded the scope of the business judgment rule in corporate control contests in recent years beyond what many peviously perceived the limits to be. Thus, Delaware has approved corporate adoption of poison pills, see *Moran* v. *Household International, Inc.*, 500 A.2d 1346 (Del. 1985), and allowed companies to engage in discriminatory self-tenders of a type that would raise howls of outrage if attempted by a corporate raider, see *unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

See also, Seagram v. Abrams, 510 F. Supp. 860 (S.D.N.Y. 1981); Norlin Corp. v. Rooney, Pace Inc. 744 F.2d 255 (S.D.N.Y. 1984); Asarca Inc. v. Court 506 F. Supp. 468 (D.C.N.J. 1985); Minstar Acquiring Corp. v. AMF Inc. No. 85 Civ. 3800 (S.D.N.Y. 1984); Dynamics Corp. of America v. CTS Corp. 795 F.2d 250 (7th Cir. 1986); Amalgamated Sugar Co. v. NL Industries No. 86 Civ. 5010 (S.D.N.Y. 1986); AC Acquisitions Corp. v. Anderson, Clayton & Co. No. 8584 (Del. 1986); Dynamics Corp. of America v. CTS Corp. 805 F.2d 705 (7th Cir. 1986); Buckhorn, Inc. v. Ropak Corp. 656 F. Supp. 209 (S.D. Ohio 1987).

[21] Del. Code Ann. tit. 8, S. 102(b)(7) (1983 Supp. 1986).

ing, corporate executives have warned Congress of the parade of horribles that accompany corporate takeovers. The alarm sounded by corporate America has been cleverly designed to play to the parochial interests of legislators who have every right to be concerned about the effect of *all,* not just hostile, takeover activity on corporate constituencies—constituencies which include management, labor, consumers, affected communities and state and local governments. The alarmists apparently have chosen to ignore the real, long-term benefits to the U.S. economy from both friendly and hostile takeovers which are discussed below in Part I, Section D.

Under the guise of legislation designed to restrict takeover activity and thereby lessen the adverse impact of corporate takeovers on these corporate constituencies (constituencies which are given short shrift by corporate executives in other contexts),[22] the corporate lobby in Washington has been in hot pursuit of several legislative proposals that promote their interests and theirs alone.

Special protection for the inhabitants of the executive suites is driving legislation such as S. 1323, which they attempt to hide under the very thinnest veneer of takeover reform. This legislation can only be considered reform, it is reform to outlaw a business transaction that has provided real economic benefits to shareholders and the economy solely because the target's managers oppose the transaction. Despite the protestants of the business lobby, the overriding theme of legislation moving through Congress remains the grant of increasing autonomy to corporate management by insulating them from the very owners of the corporation. These proposals amount to a declaration of war on corporate takeovers, as well as shareholders who are exercising their legitimate rights.

During the course of this legislation struggle, nothing has been more admirable than the fortitude with which corporate executives, especially those leaders of Fortune 500 companies who have become regular witnesses in Congressional hearings, tolerate the disadvantages of their position. In an effort to seek assistance in easing the burdens of corporate leadership, these corporate executives argue that they are besieged by foreign competitors, beleaguered by corporate raiders and, most recently, betrayed by the avarice of their own shareholders. Congress has responded. To become more competitive they have received protection from foreign competitors as well as increased protection from corporate raiders and greenmailers. In their most recent appeal to Capitol Hill, they asked for—and are well on the way to receiving—protection from their own shareholders.

The arguments espoused by the proponents of anti-takeover legislation such as S. 1323 become even less credible when the myriad of defensive tactics available to America's largest corporations are considered.[23] Anti-takeover measures adopted by corporations have

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[22] For example, corporate opposition to plant closing legislation has been extremely strong in the 100th Congress. For a detailed examination of the politics of plant closing legislation, *see* Plant Closing: Advance Notice and Rapid Response, Office of Technology Assessment, Congress of the United States (Sept. 1986); Gordus, Jarley and Ferman, *Plant Closings and Economic Isolation* (Upjohn Institutes: 1981).

[23] See, V.K. Rosenbaum, *Takeover Defenses Profiles of the Fortune 500* (Investor Research Responsibility Center: 1987).

proliferated in recent years. Studies by the Investor Responsibility Research Center (IRRC)[24] show that almost 80 percent of the Standard & Poor's (S&P) 500 companies have adopted some form of anti-takeover measures:

—146 of the S&P 500 companies had fair price charter provisions as of December 1985, compared with only 85 as of October 1984;

—206 of the S&P 500 companies had classified boards as of December 1985; compared with 154 as of October 1984;

—328 had authority to issue "blank check" preferred stock at the end of 1985, compared with 316 in 1984;

—170 had adopted charter or bylaw provisions that limit the rights of shareholders to act by written consent, amend the bylaws, or call special meetings; and

—214 of the 500 companies have some form of benefit package for top executives if they quit or are fired following a change of control.[25]

In the area of "greenmail," companies have adopted charter or bylaw amendments requiring that shareholders vote to approve any greenmail payment, thus sending a warning to potential greenmailers that the decision has effectively been taken out of management's hands. The IRRC study found that in 1985, 33 of the S&P 500 companies had adopted anti-greenmail charter provisions, compared with two in 1984.[26]

The IRRC also reported that after the "record-setting pace in 1985, the number of companies proposing anti-takeover measures was falling in 1986.[27] However, "poison pills," which can be adopted without a vote of shareholders, have increased dramatically. The IRRC survey showed that by the end of 1985, 43 of the S&P 500 companies had adopted poison pills, compared with only four at the end of 1984. The Delware court's affirmation of Household International Inc.'s poison pill in November of 1985 resulted in a rush by companies to adopt these devices.[28] In a July 31, 1986, release,[29] the SEC noted that while approximately 37 companies had poison pills in place on the date of the *Household* decision on November 19, 1985, by midsummer of 1986, at least 190 companies had adopted poison pills, and it was believed the number will increase substantially unless the use of these devices is curbed by court decisions. The Commission therefore sought public comment on the subject of poison pills in order to fully develop facts on the number of poison pill plans; the impact of these plans on shareholders, takeovers and proxy contests; the "appropriateness of federal intervention into the area of poison pills," and what form, if any, that intervention should take." [30] By the end of 1986, it was

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[24] Investor Responsibility Research Center, Inc. *Antitakeover Charter Amendments: A Directory of Major American Corporations* (IRRC 1985); and Antitakeover Charter Amendments, 1985 Supplement, (IRRC 1986).

[25] IRRC, *1985 Supplement*, pp. 2-3.

[26] *ID.*

[27] IRRC *Corporate Governance Bulletin* (June, 1986), p. 39. A "review of more than 800 companies that held meetings through the end of May, 1986, showed that only 13 percent have proposed anti-takeover provisions this year, compared with 22 percent during the same period in 1985."

[28] Moran v. Household International Inc., 500 A.zd 1346 (Del. 1985).

[29] Release No. 34-23486; S7-18-86; 17 CFR Part 240.

[30] *Id.*

estimated that more than 300 major American corporations had adopted poison pills.[31]

A grant of further protection by enacting S.1323 is unwarranted by any objective or reasonable standard. Noted economist Robert Samuelson correctly observed that the bill gives corporate managers the "divine right of management" in which "bankruptcy [will] become virtually the only way top executives [can] lose their jobs." [32] By exercising this divine right in an attempt to persuade official Washington, chief executive officers and their energetic lobbyists must have rung up quite an impressive tab. No doubt this expense, as is the case with the costs of other defensive tactics and the costs of lobbying state legislators, will ultimately be borne by the shareholders, from whom the chief executives want protection.

Congressional concerns over the challenge presented to corporate America by contests for corporate control has becomes manifest in two pieces of legislation that have recently been approved by Congressional Committees. The first, S. 1323 contains several provisions intentionally designed to prohibit or to impede corporate takeover activity. Although the legislation was initially flawed, it became even more deficient in certain respects when attempts to restrict the award of golden parachute agreements, curtail the use of poison pills and increase shareholder democracy were defeated. A provision designed to prevent the payment of greenmail was also amended so that only the recipients of greenmail, and not the corporate executives who make the determination to pay greenmail, are subject to liability. Thus, the Senate Banking Committee has statutorily confirmed the age old adage: "it is truly better to give than to receive." As Forbes magazine observed, S. 1323 represents the legislative triumph of corporate America because S. 1323 "could offer wonderful protection for executive power and perks." [33]

Second, and an even more destructive bill than S. 1323, was the attempt, through the House Ways and Means Committee's manipulation of the tax code, to kill all takeover activity. H.R. 3545, the Omnibus Budget Reconciliation Act of 1987 contains five corporate control provisions that would chill takeover activity. Market professionals have attributed the inital drop in the Dow Jones average on October 16, prior to the 580 point drop on October 19, 1987, in significant part to the anti-takeover provisions of the bill approved by House Ways & Means Committee in a partisan vote.[34] This leg-

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[31] M. Lipton "A Sensible Deterrent to Takeover Mania," The New York Times, Dec. 14, 1986, p. 2F.

[32] Samuelson, Shielding Management, the Washington Post, Business Section, p. 1, Wednesday Sept. 23, 1987.

[33] Saunders, *The War on Takeovers*, Forbes, Nov. 30, 1987 at 116.

[34] The announcement of the Ways and Means Committee's tax proposals during the week prior to October 19 could well have helped precipitate a broad market decline. The Stock price evidence indicates that the market declined on both days following announcement of the Ways and Means Committee's actions. The Committee announced initial agreement on the tax proposals on Tuesday, October 13, after the market closed. On Wednesday, October 14, the S&P 500 declined by a statistically significant 2.95%. The Committee approved the bill Thursday night, October 15, and on the 16th the S&P 500 declined by a statistically significant 5.16%. The surprise nature of the Committee's recommendations, their rapid adoption, their substantial implications for the value of capital in place, and the presence of consistent stock price data suggest that there is a probable relationship between the takeover tax proposals and the October decline. *See*, Letter from SEC Commissioner Joseph Grundfest to the Honorable Dan Rostenkow-

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islation demonstrates the extent to which many members of the corporate community will go to kill corporate takeovers. It seems that they will support this anti-takeover legislation and save their jobs even if it has the effect of triggering a crisis on Wall Street and threatening the economic well being of this nation and millions of blue collar jobs.

The most dubious distinction to be earned by the anti-takeover proposals emanating from the Senate Banking and House Ways and Means Committees is that both seem to have been written in total disregard of the empirical evidence of the benefits attenant to corporate takeover activity. Instead, proponents of S. 1323 rely on anecdotal evidence offered to support anti-takeover legislation offered in testimony to Senate and House Committees. The futility of presenting an empirical analysis of the takeover process was readily apparent in Senate proceedings when Committee Members effectively stated that they did not accept the arguments of the witnesses opposing the enactment of S. 1323.[35] These witnesses cited both the benefits and shortcomings of corporate takeover activity and urged the adoption of more measured takeover reforms. The hearing record also contains numerous economic studies and law review articles suggesting that, if takeover reform is to be enacted, then the protection of shareholders—rather than the entrenchment of corporate management—should serve as the appropriate legislative guideposts.[36]

D. THE ECONOMIC EVIDENCE: MYTH V. REALITY

Without retrying the entire case of the *Benefits* v. *Shortcomings* of corporate takeover activity, a few facts merit consideration since they were conveniently overlooked or ignored in the Report. Free competition for corporate control provides a powerful tool in enhancing the competitiveness of American business. Contrary to the hype over "merger mania," takeovers are breaking up inefficient conglomerates; increasing employment opportunities; prodding managers to invest in long-range projects that make economic sense; and utilizing, where appropriate, the advantages of debt capital, which can reduce financing costs and motivate managers to undertake needed changes. As in most transactions, takeovers have resulted in isolated instances of abuse. Corporate "raiders" as well as target managements have been guilty. Forms of redress, such as stockholders amending the corporate charters to prevent two-tier takeovers as well as judicial remedies, already exist to deal with actions perceived to be detrimental to the company or the shareholder.

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ski, Chairman, House Committee on Ways and Means, December 10, 1987, pp. 10–12 (letter on file with Committee); Berg, Plan for Takeover Taxes Stirs Fears in Markets, New York Times, October 19, 1987; p. D9; Klott, Trying to Find a Stock Culprit, New York Times, October 22, 1987; p. D1; Yardeni, *That M&A Tax Scare Rattling the Markets;* Wall St. J. October 28, 1987, at 32. Burroughs & Ricks, *Wall Street Fears of Proposed Tax Bill, Interest Rates, Spark Takeover Caution,* Wall St. J., Oct. 16, 1987, at 3; Coll & Vise, *What Killed Stock Boom? Some Point at Tax Idea,* Wash. Post, Dec. 13, 1987, §–H, col. 1.

[35] *See, e.g.* S. Hrg. 100–183, Regulating Hostile Corporate Takeovers, Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. (June 23, 24, and 25, 1987) (hereinafter cited as Regulating Hostile Takeovers) at pp. 136–341.

[36] *See* Hostile Takeover Hearings, pp. 373–933; and Regulating Hostile Takeovers, pp. 372–520.

Both S. 1323 and the Report represent the adoption of the position espoused by the managers of America's target corporations. The managers of America's target corporations have taken the position that incumbent management should have the power to veto all unsolicited offers, while also retaining autonomy over their own decisions to mount acquisition bids for other corporations. Clearly this is a self-serving position. Managers have tried to arrogate to themselves the power that current law vests with shareholders—namely, to decide whether the corporation should be sold. In support of this view, management lobbies have blamed takeovers for virtually every contemporary American economic problem except the size of the national debt.

The empirical economic evidence offered by the Report concerns studies that purport to demonstrate that mergers and acquisition activity do not enhance corporate efficiency.[37] The Report misinterprets the data contained in the articles it cites as authority. Several of the articles clearly state that the mergers it addressed were not hostile in nature. The merger activity addressed in these studies focuses upon conglomerate acquisitions. Substantial theoretical and empirical evidence exists that demonstrates that conglomerate mergers are least likely to involve efficiency gains. Instead, they are more likely to involve the reshuffling of assets to satisfy managers' desire to expand the size of their firms through strategies that benefit neither stockholders nor the economy.[38]

In the 1960's and 1970's, conglomerate mergers proceeded because management was to a large extent insulated from shareholders. Only in the 1980's were the financing techniques devised to enable a smaller entity to acquire a larger corporation. Not surprisingly, corporate America did not content that the Williams Act was not working while it enjoyed the position of the acquiror. Complaints regarding deficiencies in the Williams Act were heard in Congress only after the acquiring became the acquired. Further, there exists substantial evidence demonstrating that most empire-building conglomerate acquisitions ultimately fail and that acquired operations are divested.[39]

Those adopting management's viewpoint overlook much economic evidence to the contrary. The benefits from takeovers and other

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[37] It is hard to determine precisely which studies to which the Report is referring since they are not accurately identified. We assume that these studies include: Ravenscraft and Scherer, Mergers and Managerial Performance (1986); Ravenscraft and Scherer, The Long-Run Performance of Mergers and Takeovers; Herman and Lowenstein, The Efficiency Effects of Hostile Takeovers; Columbia Law School, Working Paper No. 20 (April 1986). However, as with other "evidence" cited in the Report, it is hard for the reader to ascertain the source or accuracy of the "evidence."

[38] *See, e.g.*, Levy & Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. Fin. 795 (1970); Melicher & Rush, *The Performance of Conglomerate Firms: Recent Risk and Return Experience;* Ravenscraft & Scherer, *Mergers, Sell-Offs and Economic Efficiency* 217 (Brookings Inst. 1987) (providing extensive evidence on the "dubious payoffs and appreciable risks of conglomerate merger-making.")

[39] *See* Porter, *From Competitive Advantage to Corporate Strategy*, Harv. Bus. Rev., May/June 1987, at 43 (noting the "dismal" track record of most diversification efforts by large companies); Ravenscraft & Scherer, *supra* note 26. *See also* Jensen, *The Takeover Controversy: Analysis and Evidence*, 4 Midland Corp. Fin. J. 6 (Summer 1986); Bradley, Desai & Kim, *Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms* (Journal of Financial Economics, forthcoming 1988); Asquith, Bruner & Mullins, *Merger Returns and the Form of Financing* (Harvard Bus. School Working Paper, June 1987); Lehn & Poulsen, *Sources of Value in Leveraged Buyouts* (Working Paper, Feb. 1987).

corporate control activities, now well documented in volumes of credible academic research, have been substantial.

A recent study by SEC Commissioner Joseph Grundfest conservatively estimated shareholder gains from takeover activity at $167 billion between 1981 and 1986.[40] Professor Michael Jensen of Harvard Business School has estimated shareholder gains from takeovers at $400 billion between 1977 and 1886 (in 1986 dollars).[41] Moreover, these estimates may substantially understate the true gains from takeover activity because they exclude "the more important impact of the takeover, [which] may well be on those firms and managers who are not taken over, but who change their behavior as a result of the general deterrent threat of a takeover." [42] For example, the restructurings of Phillips, Unocal and ARCO created total gains to shareholders of $6.6 billion.[43]

It's is important to recognize, moreover, that these transactions are not "zero-sum games"; that is, the huge gains to target shareholders do not simply represent wealth redistributions. Rather, as the research suggests, they tend to represent net social gains from reallocating corporate assets among competitive management teams. The conventional wisdom among financial economists is that takeovers, on average, are a form of "productive entrepreneurial activity that improves the control and management of corporate assets and moves assets to more productive uses." [44]

The Report constantly claims that the only beneficiaries of corporate takeovers are corporate raiders, speculators, and Wall Street lawyers and bankers. By making this claim, the Report overlooks one important fact: stocks are not just for the rich. One out of every five Americans owns shares of stock. Of these 47 million shareholders, two-thirds earn between $15,000 and $50,000 annually. In 1984 and 1985 alone, stockholders earned nearly $75 billion in premiums as a result of takeovers. Many of the measures now before Congress would effectively curb takeovers, thus depriving shareholders and the country of the benefits that accrue as a result of the corporate control process.[45]

Contrary to assertions that only raiders, investment bankers, and lawyers benefit from hostile tender offers, stockholders in a large variety of corporations have benefited greatly from these transactions during the past few years. These stockholders include pension funds, mutual funds, and millions of individual investors.

These gains were reinvested in the market after taxes were paid. Furthermore, while the popular wisdom is that arbitrageurs have received a disproportionate share of takeover premiums, in fact, arbitrageurs have received only a small proportion of the takeover premiums that have been paid in corporate takeovers during the past

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[40] Grundfest & Black, *Stock Market Profits from Takeover Activity Between 1981 and 1986: $167 Billion is a Lot of Money* (Securities and Exchange Commission, Sept. 28, 1987).

[41] Jensen, Disclosure Rules Harm Shareholders (Working Paper, Sept. 13, 1987).

[42] Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich. L. Rev. 1, 41 (1986).

[43] Jensen, "The Takeover Controversy: Analysis and Evidence," Midland Corporate Finance Journal, Vol. 4 No. 2 (Summer 1986), p. 7.

[44] Jensen and Ruback, "The Market for Corporate Control," *Journal of Financial Economics* (April 1983), pp. 5–50.

[45] Grundfest and Black, *Stock Market Profits from Takeover Activity Between 1981 and 1986* (Securities and Exchange Commission, Sept. 28, 1987).

few years. According to the SEC study prompted by an inquiry by Senator Proxmire, over the three-year period 1984–1986 risk arbitrageurs have captured less than 3 percent, and perhaps as little at 1 percent, of the total profits earned by shareholders in acquisitions of public companies, restructurings, and other similar transactions.[46]

Contrary to assertions that hostile takeover contribute to corporate managers "obsession with the short term," there is no evidence that institutional investors are overly concerned with short-term results or that companies that make long-term investments are more likely to become takeover targets. Within twelve months of the initial ascendence of the "short-term" theory—a theory resting on an allegedly pervasive short-term focus by the stock market in valuing corporations and a resulting widespread tendency to undervalue corporations engaged in long-term investment—several important studies emerged providing strong evidence against the main contentions of takeover critics.[47]

Contrary to many popular perceptions, there is substantial evidence that takeovers do not reduce research and development activity. Takeover targets are not more long-term oriented than are their industry peers.[48] Institutional investors do not foster takeover activity nor do they react negatively to long-term planning.[49] Takeover targets do not have lower debt levels, or cleaner balance sheets than do other firms in the market.[50] By several measures, takeover targets do not appear to be "unfairly undervalued" by the market prior to takeover.[51] Shareholders under existing state corporation law do a creditable job, through voting, of weeding out potentially harmful antitakeover provisions. However, when the voting prerogative is bridged, as is the case with so-called poison pill defenses, shareholders are harmed on average.[52]

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[46] Grundfest and Black *supra* note 40.

[47] *See e.g.*, Hall, *The Effect of Takeover Activity on Corporate Research and Development*, in A. Auerbach, ed. *The Economic Effects of Mergers and Acquisitions* (National Bureau of Economic Research, forthcoming 1988) (There is "very little evidence in the existing data that acquisitions cause a reduction in R&D spending; in the aggregate, firms involved in mergers showed no difference in their pre- and post-merger R&D performance over those not so involved."); Office of the Chief Economist of the SEC, *Institutional Ownership, Tender Offers and Long-Term Investment* (Apr. 19, 1985) (Takeover targets do less R&d on average, than other firms in the same industry that are not subject to takeovers.).

[48] Office of the Chief Economist of the SEC, *Institutional Ownership, Tender Offers and Long-term Investment*, April 19, 1985; Pound, *Are Takeover Targets Undervalued?*, (Investor Responsibility Research Center: Washington) (1986); Pound, Lehn and Jarrell, *Are Takeovers Hostile to Economic Performance*, Regulation (Sept./Oct. 1986) pp. 25–30, 55–56.

[49] A study by McConnell & Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*, Journal of Financial Economics 14, 399–422 (1985), shows that investors bid up the stock prices of companies that announce increases in capital expenditures, with the exception of oil and gas firms in the 1980s that increase their exploration budgets.

[50] *See, e.g.*, Morck, Shleifer & Vishny, *Differences Between Hostile & Friendly Deals: Asset and Ownership Structure*, A. Auerbach, ed., ("Compared to the universe of Fortune 500 firms, hostile targets are smaller, older, have lower Tobin's Qs, *more debt*, and *invest less* of their income.") (Emphasis supplied); Pound, Lehn & Jarrell, *Are Takeovers Hostile to Economic Performance?*, Regulation, Sept./Oct. 1986, at 25 (Takeover targets "do not focus more heavily on the long term . . . do not have higher cash flows . . . [and] do not have low debt.").

[51] In particular, when targets defeat takeover bids without undertaking a financial restructuring, their stock prices gradually return to the pre-bid level, and their shareholders lose the takeover premium. See Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy*, Journal of Financial Economics 11, 183–206 (1983); Asquith, *Merger Bids, Uncertainty and Stockholder Returns*, Journal of Financial Economics 11, 51–83 (1983).

[52] Ruback, *An Overview of Takeover Defenses*, Working Paper #1836–86 Mass. Inst. of Tech., 1986. Office of the Chief Economist of the SEC, *The Effects of Poison Pills on the Wealth of*

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Further, one direct measure of committment to long-term projects can be found in expenditures on research and development. Several studies have been conducted on the effects, possibly deleterious, of the recent increase in takeover activity in the U.S. corporate sector on the level and pattern of research and development activitity. These extensive investigations of research and development activity of thousands of firms from 1976 to 1986 leads to the conclusion that innovators are less likely to be acquired and in the aggregate, firms involved in mergers showed no difference in their pre- and post-merger R&D performance over those not so involved.[53] According to these studies, the record takeover years of 1984, 1985 and 1986 were also record years for research and development spending by American industry, both in total dollar expenditures and spending as a percent of sales.[54]

Futher, the SEC's Office of the Chief Economist has conducted an empirical study of this same issue that concluded:

> (1) target firms of tender offers invest less in research and development than do nontarget firms in the same industry;
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> (2) as a percentage of corporate revenues, corporate expenditures on research and development have increased, not decreased, during the past few years;
>
> (3) on average, announcements of increases in corporate expenditures on research and development are associated with positive, not negative, stock price movements. This result is contrary to the argument that the stock market is myopic and only rewards corporations that prop up short-term earnings, even at the expense of investments in valuable long-term projects;
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> (4) on average, firms with higher institutional holdings of equity have higher ratios of R&D expenditures to revenues. This result contradicts the conjecture that the proliferation of institutional ownership of equity has forced firms to become more myopic.
>
> (5) on average, target firms have less institutional ownership of equity than nontarget firms in the same industry. This result contradicts the assertion that the increase in tender offer activity largely has been fueled by the significant increase in institutional ownership of corporate equity.[55]

The results set forth above could be cited in numerous other studies, but the basic points are clear: anecdotal evidence of perceived harms associated with takeovers is no substitute for careful research into whether the alleged harms really exist. And many of the supposed evils of takeovers simply are not supported by the evidence.

Target Shareholders, Oct. 23, 1986; Office of the Chief Economist of the SEC, *the Economics of Poison Pills*, Mar 5, 1986; Office of Chief Economist of the SEC, *Shark Repellants: The Role and Impact of Anti-Takeover Charter Amendments*, Sept. 7, 1984.

[53] Hall, *The Effect of Takeover Activity on Corporate Research and Development* (National Bureau of Economic Research: Standford, 1987). Pound, Lehn and Jarrel, *supra* note 44 at 29–29; McConnel and Muscarella, *Capital Expenditure Decisions and Market Value of the Firm*, Journal of Financial Economics, 1985, pp. 399–422.

[54] Jensen, Ruback and Stiglin, *An Evaluation of Proposed Congressional Regulation of Takeovers*, Paper delivered at Brookings Institution Conference on Corporate Takeovers, Sept. 21, 1987.

[55] Office of the Chief Economist of the SEC, Institutional Ownership, Tender Offers and Long-Term Investments, *supra* note 47.

Critics of takeovers have recently begun to attribute differences in the performance of the United States, West German, and Japanese economies to different takeover regulations. This simplistic approach is inappropriate. Numerous factors explain international differences in economic performance, including domestic macroeconomic conditions, currency exchange rates, and differences in domestic regulatory environments. Furthermore, Japanese corporations traditionally have been more highly leveraged than American corporations. To lament the recent increase in corporate debt levels, while extolling the virtues of the highly leveraged Japanese approach to corporate management, is contradictory. Indeed, it may well be that high ratios of debt to equity, combined with significant ownership by the debtholders, a pattern found both in Japan and in leveraged buyouts in the United States, improve economic performance in at least some sectors of the economy.

The Report also errs by citing the statements of witnesses appearing before the Committee, which are unsubstantiated by any empirical evidence, to support the conclusion that the restructuring attendant to successful and failed takeover attempts has proven harmful to the economy in general. The available empirical data on this issue strongly suggests that the restructuring attendant to corporate takeovers has proven beneficial to the companies undertaking a restructuring as well as the economy in general.[56] These studies found that those sectors of the economy that have experienced increased levels of merger and acquisition activity in the 1980's have shown above average increases in productivity. In addition, the wave of takeover activity which began in the 1980's has coincided with a period of unparalleled economic prosperity in this country.

The Report's condemnation of corporate takeover activity is misplaced and its analysis of the facts related to this activity is flawed. For example, the Report apparently finds fault with the restructurings that have occurred in the oil industry. A substantial body of research (cited in the Views) completed over the last 5 years reveals that the Report ignores both the simple facts regarding shareholder gains from takeover activities and the cataclysmic change that occurred in the oil industry in the period 1973–1979.

Contrary to the Report's assertions, the shareholders of Gulf, Phillips and Unocal earned gains totaling $9.6 billion as a direct result of these takeover attempts. Simple analysis indicated the oil industry was awash in excess oil, a point illustrated graphically by the prospect of oil prices dropping to $10 per barrel oil and now clear to most people in the industry. The sensible strategy is to conserve our scarce resources and postpone exploration for a time when the reserves are required. The undiscovered oil will not disappear; it has been there for millions of years.

The tenfold increase in oil prices caused by middle eastern nations meant that the quantity of oil demanded would fall as consumers turned to conservation. This in turn meant that the indus-

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[56] Paulus and Gay, *Is America Helping Herself? Corporate Restructuring and Global Competitiveness* (Morgan Stanley & Co. 1987); Paulus, *Competition Junk and the Merger Wave of the 1980s* (Morgan Stanley & Co. 1987); Jensen and Ruback, *The Market for Corporate Control: The Scientific Evidence*, Journal of Financial Economics, vol. 11, no. 1 (1983). Magnet, *Restructuring Really Works*, Fortune, March 2, 1987, p. 42.

try would be swimming in excess inventories of oil (reserves) that were calibrated to a much higher level of demand. Thus, a major problem faced by the industry was how to reduce its reserves, and this could only be accomplished by reducing expenditures on exploration for new oil. The waste in the oil industry was caused by its managers' inability to recognize this surplus and to cut back on wasteful exploration expenditures. It took takeovers to stop this waste of resources.

Further, corporate restructuring does appear to be enhancing the competitiveness of our nation's producers. In the process, substantial value has been created through altered ownership, redeployment of assets, and the overhauling of management. In a sense, this conclusion should not be surprising since the stock market has consistently awarded premium values to target companies involved in financial restructuring. And it should help to discredit those who worry that stock market advances of recent years have been based upon "speculative excesses" associated with "takeover fever." Takeovers do not represent a mere shuffling of paper as ownership changes, but rather reflect fundamental alterations in the deployment of assets which have induced major improvements in productivity which will restore American competitiveness in global markets. This implies further substantial downward pressures on costs in the U.S. and on inflation. In short, continued corporate restructuring represents not only the nation's best hope for resolving our current trade problems, but also will keep inflation remarkably quiescent for the foreseeable future.[57]

The restructuring that "voluntarily" occurs due to the possibility of takeover activity in an economy spurs change. The managements of Martin Marietta, Phillips Petroleum, Diamond International, Continental Group and Walt Disney Productions (corporations that were subjects of takeover attempts), have stated publicly that the takeover threat benefitted their companies.[58] The most current example of a corporation whose management stated that the company was more efficient after a takeover attempt was made on Enron Corporation. The Chairman and Chief Executive Officer of Enron, Kenneth Lay, stated that the overall net effect of corporate raiders has been positive for the economy and the energy industry. Lay stated that "the raiders made Enron rethink its strategies . . ., there was a good chance of it [changing strategies] never happening. . . [Although Lay disagreed with the raiders style] Lay said it is difficult for a free market proponent to say corporate raiders don't have a right to do what they do." [59]

Examples of productive restructurings which have occurred as a result of a hostile tender offer include, among others:

(1) Union Carbide's divestitures in response to GAF Corporation's 1985 tender offer. Since 1985, $3.8 billion in asset sales have been made, including the sale of its Eveready Battery division to Ralston Purina (with a strong existing consumer products operations) and the sale of its agricultural chemicals

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[57] Paulus and Gay, *supra* note 56, at 21.

[58] Jensen, A Program for Stagnation, Not Growth, Working Paper, Simon School for Business Administration, July 16, 1987 (paper on file with Committee).

[59] Antosh, *Raiders Help Economy, Lay Says*, Houston Chronicle, *Sept. 17, 1987, p. D1.*

division to Rhone-Poulenc (which has strong sales distribution capabilities). In connection with the restructuring, the company's market value has grown by over 110 percent to approximately $5.6 billion.

(2) Uniroyal's restructuring in response to a 1985 tender offer. From 1968 to 1979 Uniroyal's stock declined from $607 million to $68 million as a result of excessive corporate overhead, poorly positioned product lines, operations of an insufficient scale to allow Uniroyal's tire operations to compete effectively in the global marketplace, lack of management focus, and insufficient capital. In response to a 1985 tender offer, Uniroyal divested, rather than closed, its chemicals, plastics, and power transmission segments, allowing them to continue to operate. Management retained the tire operations and merged them with Goodrich, which had complementary produce lines. 96 percent of Uniroyal's work force was retained and the joint venture now ties Michelin and Bridgestone for second place in world markets. Goodrich stock has increased in value 65 percent since the joint venture. The value of Uniroyal's chemical subsidiary, Avery has increased 100 percent since divestiture.

(3) James River Corp., after purchasing the paper manufacturing operations of Crown Zellerbach, Diamond International and American Can, has more than doubled the operating incomes of the three operations.

Proponents of anti-takeover legislation speculate that funds used to finance hostile takeovers are funds that are unavailable for investment in plants and equipment. Such arguments overlook the obvious fact that the premiums paid in corporate takeovers are neither shredded nor burned. They are typically reinvested in the securities markets, which facilitates investment projects elsewhere. Although the benefits associated with the reinvestment of takeover premiums are difficult to measure, undoubtedly these benefits include increased employment opportunities.[60]

The Report also erroneously states that the bondholders of corporate takeover targets are injured by the additional debt incurred by hostile takeovers. First, if this is the case, then the same arguments apply with equal strength to friendly offers, mergers and leveraged buyouts. Second, the Report's conclusions are wrong. Empirical evidence counters the Report's suggestion that premiums paid by bidders are not a result of any wealth enhancing changes, but instead represent a redistribution from the holders of the target's bonds and preferred equity. For example, the bonds of an acquiring firm can drop in value if the acquiring firm pays cash for a

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[60] During the three year period 1984-1986, stockholders realized more than $93 billion in gains as a result of acquisitions of publicly traded corporations. These figures are derived from data gathered in W.T. Grimm & Co., *Mergerstat Review* (published annually), as compiled and analyzed in Grundfest & Black, *Stock Market Profits from Takeover Activity Between 1981 and 1986*, at 12-13 (Securities and Exchange Commission, Sept. 28, 1987).

This figure may understate the gains to target shareholders because it excludes "the more important impact of the takeover, [which] may well be on those firms and managers who are not taken over, but who change their behavior as a result of the general deterrent threat of a takeover." Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich L. Rev. 1, 41 (1986). *See also* Jensen, *The Takeover Controversy: Analysis and Evidence*, 4 Midland Corp. Fin. J. 6, 19 (Summer 1986) (estimating stock price gains of $3.2 billion from Arco's restructuring in 1985); Gilson, *The Law and Finance of Corporate Acquisitions* 4-8 (Supp. 1987).

riskier target firm. Given that the combined value of the two firms remains unchanged, the decline in the bond value will be captured as a gain by some other class of security holder (such as common stockholders). However, the empirical evidence does not support this argument.

The empirical evidence demonstrates that the gains associated with merger activity do not hurt bond holders. The evidence indicates that on average holders of common stock, convertible and non-convertible preferred stock and convertible bonds in the acquired firm gain from a merger. Those who hold non-convertible bonds in the acquired firm and convertible bonds, non-convertible bonds, and non-convertible preferred stock in the acquiring firm neither gain nor lose in a merger. Further, studies of leveraged buyout disproves the theory that the shareholder value created the leveraged buyouts comes at the expense of preferred shareholders or bondholders. In sum, the evidence provides no support for the hypothesis that the supposed gains from acquisitions are actually transfers from the holders of senior securities to the holders of common stocks.[61]

While takeovers, in additional cases, sometimes are associated with job losses, there is no systematic evidence that takeovers, or the threat of takeovers, reduce overall employment. Most studies that consider job loss and takeovers, including the AFL-CIO's estimate of 80,000 lost jobs, are inaccurate because they fail to adjust non-takeover related job losses. Exxon, for example, has cut back its employment from 182,000 in 1981 to 102,000 in early 1987 prior to any takeover attempt. Adjusting all job loss estimates to account for large economic trends is essential. To blame all layoffs at merged companies on takeover activity simply distorts the data.

Contrary to the unsubstantiated conclusions contained in the Report, there is little evidence that takeovers lead to loss of job. By providing an alternative to plant closings, mergers and acquisitions often actually save jobs.[62] A study conducted at the State University of New York at Stony Brook found that less than two percent of the job loss resulting from plant closings that occurred in New York and New Jersey since 1978 was associated with corporate takeovers. Most job loss is attributable to changes in supply and distribution, import penetration, and appreciation of the U.S. dollar.

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[61] See Dennis and McConnell, *Corporate Mergers and Security Returns*, Journal of Financial Economics pp. 143 (1986). Dennis and McConnell examine the returns on various classes of the securities of a sample of 132 mergers in the period 1962 to 1980. They find that there are no losses to bondholders. They also find evidence that the acquiring firms' shareholders do not lose from mergers; Lehn and Poulsen, *Sources of Value in Leveraged Buyouts*, Working Paper (1987) cited in Jarrell, Brickley and Netter, The Market for Corporate Control: The Empirical Evidence since 1980, at 12. Lehn and Poulsen studied 108 leveraged buyouts from 1980–1984 and find no evidence that shareholder gains are offset by bondholder losses.

[62] *See e.g.*, Brown & Medoff, *The Impact of Firm Acquisition on Labor* in A. Auerbach, ed., *supra* note 15, ("Contrary to the tenor of public press coverage of acquisitions, we find that wages generally grow faster following acquisition. . . . We also find employment grows faster."); Yago & Stevenson, *Mergers and Acquisitions in the New Jersey Economy*, Economic Research Bureau, State Univ. of New York, Stony Brook (May 8, 1986) (Acquisition activity "has little generalizable effect on employment."). *See also*, General Accounting Office, Preliminary Analysis of U.S. Business Closures and Permanent Layoffs During 1983–1984, April 30, 1986; Yago, *Mergers and jobs*, paper presented at Conference on High Yield Bonds, Los Angeles, Calif. (Apr. 3, 1987).

By contrast, those Fortune 500 companies that have not been takeover targets have eliminated 2.5 million jobs since 1981. Over 350,000 jobs have been eliminated by Exxon, GE, AT&T and GM since 1983. None of these corporations have been threatened by takeovers.

Finally, the U.S. Labor Department reported the lowest rate of unemployment in over a decade for October 1988. According to the Labor Department, more people are working in America today than ever in our history. The U.S. economy has created over 13 million new jobs since 1981 despite cutbacks by large firms. Thus, at a macroeconomic level, there appears to be no connection between takeovers and job loss; rather, competitiveness gains from takeover may well increase employment throughout the economy in the long-run.

A recent study conducted by the National Bureau of Economic Research, which properly adjusts employment data for larger trends in the economy, properly concluded that "contrary to the tenor of popular press coverage of acquisitions, we find that wages generally grow faster following acquisitions [and] . . . employment grows faster." [63]

Indeed, it is the changes in macroeconomic conditions, technological innnovations, growth opportunities, and new investment opportunities, that both motivate takeovers and redistributions of jobs. Furthermore retarding the takeover market will, in the long run, reduce national income, cost jobs, impede corporate efficiency and hence, decrease the international competitiveness of U.S. corporations.

Finally, the job losses pursuant to takeover activity that most corporate managers seem to be preoccupied with are their own. Recent research reveals that on average 62% of the top management team of an acquired company are gone within three years after an unfriendly takeover, while only 21% of the top managers of non-merged companies leave in the same period.[64] A Federal Trade Commission study suggests the reasons top managers want to shut down takeovers: the "statute [referring to the New York State anti-takeover law] does not protect shareholders; rather, the law protects managers at the expense of shareholders."[65] Thus, the principal beneficiaries, with regard to the issue of job loss, of state anti-takeover statutes and S. 1323 are corporate managers—the very group that has lobbied strongly for such legislation.

Frequently, critics of takeover activity cite as empirical evidence to support their position, studies demonstrating that corporate merger activity in the 60's, 70's and early 80's have proven unproductive. Ironically, these studies demonstrate that the failures of the conglomerate mergers of the past that have led in part to the current phenomena of the bust-up takeover. The most vociferous critics of hostile takeover activity are those who are attempting to

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[63] Brown and Medoff, *supra* note 62.

[64] Jensen, et. al., *supra* note 54 citing a study prepared by Professor James Walsh of Dartmount College.

[65] Schumann, State Regulation of Takeovers and Shareholders' Wealth: The Effects of New York's 1985 Takeover Statutes," Federal Trade Commission, March 1087; *See also* Office of the Chief Economist, "Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers," Securities and Exchange Commission, May 18, 1987.

preserve, without any economic justification, their inefficient corporate conglomerate empires at the expense of the company's shareholders and the economy in general. It is no wonder that the defenders of the conglomerate faith are also leading the crusade against the real threat to their corporate culture—corporate restructuring accomplished through contests for corporate control.

The hysteria created by the corporate opponents of takeover activity has ultimately manifested itself in the ultimate arbiter of public policy—the public opinion poll. Critics of corporate takeover activity cite with great relief the results of a Harris Poll that affirms their view that the American people are united with corporate America in the fight against corporate takeovers.[66] The value of this poll in drafting legislation aimed at thwarting takeovers which benefit shareholders is at best questionable and at worst totally irrevelant.

The poll would have proven more dispositive on the "mood" of the American people if those polled had been asked to offer their opinions on the quality of corporate leadership in America or whether they, their IRA's or pension funds benefitted from the stock premiums paid through takeover activity. Finally, the results of this poll should be discounted when, according to figures contained in a recent edition of Harper's magazine, at last count, 50 percent of the American population believed an accused individual guilty until proven innocent; 50 percent did not know which side the United States supports in Nicaragua; 42 percent could not name an Asian country near the Pacific Ocean; and 40 percent of the nation's high school seniors thought Israel was an Arab country.[67]

At present, in the vernacular of Wall Street, Congress is considering legislation that is long on management protection and short on investor protection. For the first time, the bills, if enacted, will replace the Williams Act's guiding principles of equal treatment of all shareholders by permitting, if not requiring, the discriminatory treatment of large shareholders, especially large shareholders that do not meet management's approval.

E. HOSTILE TAKEOVERS AND INSIDER TRADING

The Report suggests that the curtailment or elimination of hostile takeovers will have a corresponding effect on insider trading. Insider trading activity will not be eliminated by the elimination or curtailment of hostile takeover activity. First, a myriad of securities transactions other than takeovers are susceptible to insider trading. Second, SEC statistics reveal that the overwhelming majority of the insider trading cases that have been brought to date have been brought against corporate insiders, their families and friends, rather than Wall Street professionals.[68] Third, the opportunities, motivation and incidence of insider trading should be less in hostile takeovers than in friendly offers since fewer people know about the transactions. SEC statistics reveal that the incidence of

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[66] *See, e.g.*, S. Hrg. 100-183, Regulating Hostile Takeovers, p. 80 and 108.

[67] Harper's Index, Harper's Magazine, August, 1987, p. 11.

[68] This information was complied from a review of SEC Enforcement Division cases brought from 1980 to the present.

insider trading is greater with regard to friendly offers and mergers as compared to hostile acquisitions.[69]

Hostile takeovers are not uniquely susceptible to insider trading, nor do they cause insider trading. For example, insider trading occurs in friendly transactions, even where the parties are not subject to hostile takeover threats and even where substantial efforts are made to keep the transactions secret. When Nestle, S.A. sought to acquire Carnation Company, Nestle informed Carnation that it would terminate the discussion if there was any public disclosure by Carnation of Nestle's contacts with the company.[70] Martin Siegel, who was Carnation's investment banker, participated in the friendly negotiations that both Carnation and Nestle sought to keep secret. Siegel disclosed to Ivan Boesky material nonpublic information about the friendly deal. Based on the information Siegel provided, Boesky netted profits of $28.3 million.[71]

In another case, an analyst with an in vestment banking firm, obtained material nonpublic information about a friendly merger between RCA Corporation and General Electric Company. The analyst disclosed the information to his father, who subsequently purchased RCA shares for himself and four other friends, among others. The defendants netted over $1 million in profits.[72]

These cases suggest that friendly deals are equally, if not more susceptible to insider trading as hostile deals. Indeed, friendly deals may be more susceptible to insider trading because more people on both sides of the negotiation are likely to know of the pending deal for a longer period of time. By contrast, a hostile bidder wants to avoid tipping a target that a bid is forthcoming. These conclusions are supported, in part, by a recent study of the SEC's Office of the Chief Economist, which found substantial evidence of stock price runups prior to the announcement of friendly transactions. It also found that runups prior to friendly deals are more pronounced than runups prior to hostile transaction.[37]

Even in cases where insider trading occurs in connection with a hostile takeover, the trading does not necessarily emanate from the bidder. For example, during Mesa Petroleum Corporation's hostile bid for Unocal, one of Unocal's investment bankers tipped Siegel about Unocal's planned defensive maneuvers.[74] Unocal's defensive tactics caused the value of its shares to decline. Siegel caused his employer to purchase put options that increased in value as a result of the Unocal price decrease.

Insider trading also occurs in recapitalization transactions where no hostile takeover is pending. The SEC recently alleged that an attorney purchased options of Colt Industries, Inc. with nonpublic information concerning a recapitalization of Colt. The attorney also

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[69] *Id.*

[70] For a description of these negotiations and Nestle's interest in maintaining confidentiality *see In re Carnation Corp.*, Exchange Act Rel. No. 22,214, [1984-85 Transfer Binder] Fed. Sec. L. Rep. ¶ 83,801 (July 8, 1985).

[71] *SEC v. Siegel*, 87 Civ. 0963 (Complaint, ¶ 23).

[72] *SEC v. Harvey Katz, et al.*, 86 Civ. 6088 (S.D.N.Y. filed Aug. 7, 1986); SEC Lit. Rel. No. 11185.

[73] Office of the Chief Economist, SEC, *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?* (Feb. 24, 1987).

[74] *United States* v. *Siegel*, 87 Cr. 118 (RJW) (filed Feb. 13, 1987) (Complaint).

allegedly passed the information to friends and relatives who also traded.[75]

Corporate executives and their colleagues also engage in insider trading based on earnings news and other material developments that are unrelated to takeoves. For example, several executive officers and directors of Financial Corporation of America [76] sold company stock while in possession of material nonpublic information relating to anticipated year end losses. In another case, an officer of Diasonics, Inc. sold Diasonics stock while in possession of nonpublic information concerning anticipated third quarter losses.[77] This type of insider trading activity is at least as common as trading by Wall Street bankers and lawyers, but not as well publicized because the individual transactions are not as large and the personalities involved not as well known.

PART II

A. INTRODUCTION

In its present form, S. 1323 does not promote shareholder protection nor does it increase the role of shareholder participation during contests for corporate control. The provisions restricting the award of golden parachute contracts and the use of poison pills were stripped from the bill by its own sponsors and were defeated when offered as an amendment. Further, amendments that would have restricted the use of certain state anti-takeover statutes (frequently referred to as control share acquisition statutes and five year freeze out statutes), which disenfranchise shareholders, were defeated. Finally, an attempt to restore the principles of corporate democracy was dealt a near fatal blow when an amendment commonly cited as the "one share/one vote" amendment was defeated.

Critics of corporate takeovers often cite two-tier, creeping and partial tender offers and "market sweeps" as the type of abusive tactics which create "a shareholder's dilemma." Contrary to the claims of the business lobby, the real dilemma facing stockholders is not posed by corporate raiders who devise schemes to pressure shareholders to sell their shares at a premium above the market price. Rather, shareholders are confronted by the real dilemma of abusive defensive tactics. Such tactics are often intentionally employed by incumbent management to destroy the attractiveness of a target corporation to the detriment of that company's shareholders.[78] Another serious and real dilemma confronting shareholders

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[75] *SEC* v. *Israel G. Grossman, et al.*, 87 Civ. 1031 S.D.N.Y. filed Feb. 17, 1987), SEC Lit. Rel. No. 11359.

[76] *SEC* v. *Charles Offer*, 86 Civ. 0584 (D.D.C. filed Feb. 14, 1981), SEC Lit. Rel. No. 11008; *SEC* v. *John J. Borer, Jr.*, 86 Civ. 1204 (C.D. Cal. filed Feb. 25, 1986), SEC Lit. Rel. No. 11009 *SEC* v. *Rummonds*, 86 Civ. 0337 (E.D. Cal. filed March 24, 1986) SEC Lit. Rel. No. 11033.

[77] *SEC* v. *Anthony A. DePalma*, 86 Civ. 3541 (D.D.C. filed Dec. 30, 1986), SEC Lit. Rel. No. 11333.

[78] For recent examinations of the adverse impact of defensive tactics on shareholder wealth *see*, Gilson, *The Case Against Shark Repellent Amemdents: Structural Limitations on the Enabling Concept*, 34 Stan. L. Rev. 775 (1982); Ruback, *An Overview of Takeover Defenses* (MIT Sloan School of Management Working Paper, Sept. 1986); *Update—The Effects of Dual Class Recapitalizations on Shareholder Wealth: Including Evidence from 1986 and 1987* (July 16, 1987) (mean shareholder losses of 0.9% from dual-class recapitalizations): OCE, *The Effects of Poison Pills on the Wealth of Target Shareholders* (Oct. 23, 1986) (Mean shareholder losses of 1.7% from poison pill adoptions): OCE, *Shark Repellents and Stock Prices: The Effects of Antitakeover Amend-*

Continued

is their potential wholesale disenfranchisement through state anti-takeover laws and the demise of the New York Stock Exchange's one share/one vote rule. State anti-takeover laws and the demise of the one share/one vote rule effectively deny shareholders the control premium for their shares; thus, the shareholder receives nothing at all for the loss of the rights attendant to ownership. Assuming arguendo that the shareholder receives less than the full control premium in the early stages of a takeover contest as takeover critics contend, the shareholder still receives a value of above market price for his shares. Defensive strategies and state anti-takeover laws that impede takeover activity injure shareholders. Shareholders will receive no premiums at all if takeover bids are discouraged or eliminated. The imposition of anti-takeover devices and defensive tactics that disenfranchise often devalues the price of shares.[79] Thus, the real dilemma confronting shareholders is the loss of a valuable right, their right to vote, without receiving anything of value in return.

If S. 1323 is not significantly amended before the final Senate vote, the corporate community will have dealt a fatal blow to corporate takeover activity and thereby eliminated one of the market's disciplines on corporate management. If the discipline of corporate takeovers is eliminated or impaired, then others must be enhanced. Therefore, to offer some sembalance of balance to the legislation, other market disciplines (with the exception of bankruptcy), which could result in job loss for top executives, should be adopted. Mechanisms that provide greater shareholder input into corporate governance and which enhance corporate democracy merit inclusion in any takeover reform package.

During the Committee's consideration of S. 1323, several amendments to S. 1323 which would enhance shareholder democracy were rejected by the Committee. These provisions include: (1) the "one share/one vote" amendment; (2) an amendment requiring confidential proxy voting; (3) the shareholders' rights amendment; and (4) greenmail, golden parachute and poison pill amendments which would permit the use of these tactics only upon the approval of a majority of he company's shareholders. One of the arguments used in opposition to these amendments was that the Committee had not previously addressed the issues raised by these amendments. Subsequently, Senators Armstrong and Shelby requested Chairman Proxmire to schedule a hearing on these issues.[80] To date, no hearings have been scheduled and Senators Armstrong and Shelby have not received a response to their request.

B. ONE SHARE/ONE VOTE

One method of providing greater shareholder input into the consideration of tender offers and enhancing shareholder democracy would be the codification of the one share/one vote rule currently

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ments Since 1980 (mean shareholder losses of 3.00% from adoption of supermajority provisions, classified boards, and blank check preferred stock; statistically insignificant losses of 0.7% from adoption of fair price/supermajority provisions).

[79] *See* notes 52, 65 and 78 *supra.*

[80] Letters from Senators Armstrong and Shelby to Senator Proxmire, October, 1987 (Letter on file with Committee).

under consideration by the SEC.[81] The amendment would permit existing securities that have different voting rights to continue to be traded since all investors are on notice and understand the effect of owning such securities, and since it would be disruptive and unfairly burdensome to require that these existing securities with disparate voting rights be changed. The amendment grandfathers existing dual class capitalization structures. The amendment prevents future disenfranchisement of shareholders through the adoption of unequal voting plans that are becoming increasingly common. The effective date of 180 days after enactment was designed to ensure minimal disruption in the capital markets for equity issues coming to market.

The principle of one share/one vote appears to have widespread support among the nation's stockholders. Sentiment at the SEC's hearings last December on the New York Stock Exchange's proposal to drop its one share, one vote listing standard was overwhelmingly in favor of preservation.[82] Both the Council of Institutional Investors and the United Shareholders Association have endorsed the one share/one vote principle. And in a recent survey of its members, the New York Society of Security Analysts reported that 93 percent of the respondents said that each share of common stock should have one vote on all shareholder voting matters.[83]

Although the one share/one vote rule under SEC consideration would require all major securities markets to adopt rules that would prevent disenfranchisement of existing shareholders, legislation in this area is needed. Some commentators, most notably the American Bar Association ("ABA"), have taken the position that the Commission lacks authority to require the exchanges and the National Association of Securities Dealers to adopt rules to protect shareholder voting rights. At least one member of the Commission also appear to have some doubts about its authority.[84]

Therefore, even if the SEC adopts a rule requiring a modified form of one share/one vote, the validity of the rule may be tied up in the courts for years. Rather than permit this to happen, Congress should act.

If the Committee prefers to leave the question of protecting shareholder voting rights to the SEC, then, at a minimum, S. 1323 should contain a specific provision granting the SEC the authority to prescribe voting standards to address the one share/one vote issue.

Contrary to Senator Proxmire's suggestion during the markup session that the issue of one share/one vote had not been considered by the Committee, Committee hearing records contain considerable expert testimony on the topic. The need for a federally mandated one share/one vote provision was debated at great length

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[81] *See* Securities Exchange Act Release No. 34-24623, 52 Fed. Reg. 23665 (1987) (notice of proposed rule 19c-4 concerning dual-class recapitalizations).

One share/one vote provisions are contained in legislation under consideration by the House Energy and Commerce Committee. H.R. 2172, The Tender Offer Reform Act and H.R. 2668, The Securities Trading Reform Act, 100th Cong. 1st Sess. (1987).

[82] *See generally,* Securities and Exchange Commission Hearing on Voting Rights Listing Standards and Disenfranchisement, July 22, 1987.

[83] Corporate Governance Bulletin, IRRC, vol. 4, no. 3, May/June 1987, p. 73.

[84] *See, e.g.,* the separate statement of SEC Commissioner Fleischman accompanying proposed Rule 19c-4.

during hearings conducted by the Securities Subcommittee in the 99th Congress.[85] Senator Proxmire participated in these hearings.

Support for the concepts embodied in the one share/one vote amendment can be found in more recent testimony presented to the Committee. Alan Greenspan stated: "the requirement that all shareholders obtain the same value for their shares in a takeover seems consistent with existing protections of property rights. . . ." He further expounded this idea by concluding that, ". . . if you remove from the value of a share rights the value of voting rights, a share has got to be reduced in its value to a certain extent." [86] In addition to Greenspan's testimony, Felix Rohatyn, a partner at Lazard Freres & Co., included in his list of recommendations to the Committee, a provision to "re-establish the principle of one share/one vote." [87] Finally, Harrison J. Goldin, New York City Comptroller, said, ". . . I urge the Committee to . . . consider mandating for shareholders the elemental rights of citizenship: the right to elect directors and make decisions through referenda by secret ballot; the right of one share/one vote; the right to approve certain critical decisions that affect the value of assets. . . ." [88]

C. CONFIDENTIAL PROXY VOTING

If the check on management accountability provided by hostile takeovers is weakened by the anti-takeover provisions of S. 1323, then some mechanism must be put in place so that shareholders have an alternative means of ensuring corporate accountability. An amendment which would provide for confidentiality of the voting in proxy contests provides such a mechanism and is consistent with the notion of corporate democracy. Such an amendment was defeated by a tie vote (10–10) during the Committee's consideration of S. 1323.

As with the amendment requiring one share/one vote, this provision encourages management and director accountability and responsibility. While each provision of S. 1323 described in Part III is intended to reduce the pressure corporate takeovers impose upon directors, this amendment could limit whatever director accountability might be lost by the enactment of these provisions and remove inappropriate management deterrents to fair takeover attempts.

The Confidential Proxy Voting amendment protects the rights of all shareholders against undue pressure from any group, either bidders or target management, by requiring that: (1) all proxies be voted in a confidential manner; and (2) they be returned to and

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[85] *See*, S. Hrg. 99-187, Impact of Corporate Takeovers, Hearings before the Senate Committee on Banking, Housing and Urban Affairs, April 3 and 4, and June 6 and 12, 1985, pp. 1098–99, 1106–1118, 1227–1229.

[86] "Hostile Takeovers," January 28, 1987, p. 27.

[87] "Hostile Takeovers," January 28, 1987, p. 29.

[88] "Regulating Corporate Takeovers," June 25, 1987, p. 348; "Hostile Takeovers," Committee on Banking, Housing, and Urban Affairs, United States Senate, 100th Cong., 1st Sess., March 4, 1987, p. 130. Hereafter cited as "Hostile Takeovers"; "Hostile Takeovers," March 4, 1987, p. 140; "Regulating Hostile Corporate Takeovers," Committee on Banking, Housing, and Urban Affairs, United States Senate, 100th Cong., 1st Sess., June 25, 1987, p. 350. Hereafter cited as "Regulating Hostile Corporate Takeovers"; "Regulating Hostile Corporate Takeovers," June 24, 1987, p. 225; Remarks before the American Corporate Counsel Association, November 13, 1987, p. 5.

counted by an independent third party and not by individual designated by incumbent managers as is current practice.

Confidential voting is vital because shareholder suffrage is the principal means of maintaining management accountability to shareholders. Abuse of the proxy voting system has assumed even greater significance as federal and state anti-takeover legislation reduce management accountability to shareholders. The integrity of the corporate governance system is undermined by the absence of a fair and confidential voting process. Currently, when corporations hold elections, management prepares the ballot, sends it to shareholders, tallies the returns, and announces the outcome of the voting. Management is allowed to control every aspect of the voting process in which it has a direct interest. Management proxy proposals prevail because management controls the proxy voting system. This built-in bias in favor of management is undemocratic and unfair. Numerous studies and government reports have borne this out. For instance, an Investor Responsibility Research Center ("IRRC") study entitled *Conflicts of Interest in the Proxy Voting System* ("IRRC Study") concluded that "[t]he voting system is dominated by corporate management, which has a strong vested interest in the outcome of controversial or contested items that are put to a shareholder vote. . . . The voting process itself, . . . is vulnerable to fraud." [89]

Allegations of abuse and fraud are constantly being voiced with regard to the current proxy system. Because voting is not confidential, management is able to pressure shareholders—particularly institutional investors—to vote for its position.[90] Not surprisingly, management often exerts its greatest pressure on institutional investors and fiduciaries of corporate pension funds. Fiduciaries rely upon corporations for their business so that they often feel compelled to vote with management regardless of their true position on a particular issue. One highly respected Wall Street stock analyst outlined the severity of this problem as follows:

Confidential voting would eliminate this conflict. This intimidation must be stopped by democratizing the current proxy system. This coercive system of voting must be changed so that all shareholders can cast their ballots confidentially and in secret and have them received, tallied, and the outcome determined by an independent, unbiased third party.

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[89] Heard and Sherman, *Conflicts of Interest in the Proxy Voting System*, p. 1 (Investor Responsibility Research Center, Mar, 1987).

[90] The need for a confidential voting amendment to enhance shareholder democracy in proxy voting is demonstrated by management attempts to influence votes on poison pill. According to Department of Labor lawyers, corporate executives who direct their outside investment managers to vote against shareholders proposals challenging poison pills may be violating federal pension laws. A number of corporate pension fund sponsors have sought to influence the votes of their outside fund managers on such proposals at 1987 meetings. Corporate Governance Bulletin *supra* note 83 at 69.

The major flaw in the voting process is that management knows how each shareholder votes. As a result, employees are loath to vote against their superiors. Investment analysts may not wish to offend management because it might affect their access to information. Fiduciaries, like banks, insurance companies and pension fund managers, must consider their flow of business from corporations. That fear is not confined to a single company as management can use its outside directors to add pressure from other companies. There is an implied and sometimes real prospect of retribution.[91]

[91] Heard and Sherman *supra* note 89 at 61.

Although there has been little debate on this issue in the Senate Banking Committee, the House Committee on Energy and Commerce has held hearings on this issue because both tender offer bills currently under active consideration (H.R. 2172 and H.R. 2668) contain provisions that are virtually identical to the amendment.

Not surprisingly, the corporate lobby opposes any increase in access to the proxy system or the use of a third party to tabulate the results of a proxy contest. However, groups representing shareholders, such as the Investor Responsibility Research Center, the Council of Institutional Inventors and the United Shareholders Association have endorsed the principles contained in the amendment.

The testimony of the IRRC received by the House Energy and Commerce Committee on July 22, 1987, which is summarized below, is indicative of the position of these shareholder groups. In this testimony, the IRRC Study was cited to demonstrate a number of problems associated with the current voting system that undermine the effectiveness of shareholder voting as a monitor of management performance.

> The principal finding of this report is that the voting system is not working as it should. The voting system is dominated by corporate management, which has a strong vested interest in the outcome of controversial or contested items that are put to a shareholder vote. Institutional investors, a potential check on corporate management, face serious conflicts of interest in voting, and many institutions have succumbed to management pressures to support voting proposals that are not in shareholders' interests. Management proposals that are contrary to shareholders' interests are passing overwhelmingly, even at companies that have high levels of institutional ownership. The voting process itself, which has become extraordinarily complex as a result of the nominee registration system that is used to register most securities today, is vulnerable to fraud.[92]

The IRRC Study identified several measures that would strengthen the voting system. Two of them, confidential voting and independent tabulation of results, would promote greater fairness, protect vulnerable shareholders from coercion and ensure the integrity of the voting process. The IRRC study noted that confidential voting has already been adopted voluntarily by about a dozen companies. Confidential voting and independent tabulation could be adopted at nominal cost and would not interfere with the need of corporations to communicate with their owners.

Additionally, in a recent survey of its members, the New York Society of Security Analysts reported that 75 percent of the respondents favored confidential voting.[93]

D. SHAREHOLDER RIGHTS

During the Committee's consideration of S. 1323, an amendment was offered to enhance shareholders rights to determine the disposition of their shares and the success or failure of a tender offer. To

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[92] Heard and Sherman *supra* note 89, cited in statement of James Heard to the House Energy and Commerce Subcommittee on Telecommunications and Finance, July 22, 1987, p. 9.

[93] Corporate Governance Bulletin, *supra* note 83 at 73.

avoid concerns regarding the federal preemption of state laws governing takeovers, the amendment would in no way impair the rights of the states to pass any form of state anti-takeover legislation. Currently, four types of state anti-takeover statutes have been adopted. These include the control share acquisition type statute,[94] the five year freeze out type statute,[95] the fair price type statute,[96] and the control share cash out type statute.[97]

The amendment providing for greater shareholder rights would not have invalidated any of the state anti-takeover amendments adopted to date. Instead, the amendment would have restricted the trading of securities listed on a national exchange if those securities are affected by control share acquisition or five year freeze out laws. Securities covered by such laws would have been restricted from either being traded by brokers or dealers or from listing on a national securities exchange and the NASD automated quotation system. Thus, corporations affected by control share acquisition and five year freeze out laws would be confronted by the following situation: either relinquish the protections created by these statutes when confronted by a takeover or lose the ability of having the company's shares traded over a national securities exchange or the NASD's automated quotation system.

(1) Application of the Amendment to Control Share Acquisition Statutes

Under the Indiana law, passed in 1986 and upheld by the Supreme Court in the *CTS* case,[98] the acquisition of more than 20%, 33⅓% or 50% of an Indiana corporation's stock is defined as the acquisition of "control shares," and the acquiror has no right to vote those shares until a majority of all disinterested shareholders of each class of voting stock pass a resolution permitting such voting at a specially called shareholders' meeting. The meeting must be held within 50 days after the offeror notifies the issuer of the proposed share acquisition. This statute and the others all have an exception for friendly acquisitions.

The amendment addressed control share acquisition statutes by requiring that (1) broker dealers not be able to trade in shares or (2) companies not be able to list on a national securities exchange or automated quotation system *if a shareholder's right to "acquire" or "vote" a registered security is conditioned on the approval of the issuer, its management or its securities holders.* The amendment applies in the same manner to hostile and friendly offers.

(2) Application of the Amendments to The Five Year Freeze Out Statutes

These statutes prohibit an interested shareholder—one who acquires more than a specified amount of the target's stock (usually

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[94] The following states have adopted control share acquisition statutes: Arizona, Florida, Hawaii, Indiana, Louisiana, Massachusetts, Minnesota, Missouri, Ohio and Wisconsin.

[95] The following states have adopted five year freeze out statutes: Florida, Indiana, Kentucky, Minnesota, Missouri, New Jersey, New York and Washington.

[96] The following states have adopted fair price laws: Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Michigan, Mississippi, North Carolina, Virginia and Wisconsin.

[97] The following states have adopted control share cash out laws: Pennsylvania, Maine and Utah.

[98] *CTS Corp.* v. *Dynamics Corp. of America*, 107 S. Ct. 1637 (1987).

10%-20%)—from merging with, reorganizing or engaging in any other significant transaction with the target for a period of five years following his stock acquisition unless the transaction or his purchase of stock is approved by the board of directors on or prior to such stock acquisition.

These laws can be written to prohibit a bidder from making almost any changes in the target's operations. For example, the recently enacted Washington statute prohibits a party obtaining control without management's approval from terminating 5% or more of the employees of the target or any of its subsidiaries *"whether at one time or over a period of time,"* unless the terminations are unrelated to the takeover.

The amendment addressed the five year freeze out statutes by requiring that (1) broker dealers not be able to trade in shares or (2) companies not be able to list on a national securities exchange or automated quotation system *if a controlling shareholder's right to vote his stock or to make changes in a company which he acquires is conditioned upon the approval of the incumbent managers* either prior to or at the time the acquiror obtain control.

(3) The Limited Scope of the Amendment

The amendment was designed to avoid any intrusion into the states' rights to establish the requirements for mergers, including supermajority requirements, class voting and appraisal rights. The amendment would not require companies to opt out of fair price laws or risk the loss of their ability to list on a national securities exchange or automated quotation system. Further, the amendments would not require corporations to opt out of cash out laws or risk losing their listing privileges. This results from the fact that neither fair price nor cash out laws deprive a shareholder of his right to vote shares or bar a shareholder from causing a merger because he failed to obtain some approval prior to acquiring shares.

The proposed amendment would not affect state laws which: (1) permit staggered or classified boards; (2) prohibit removal of directors except for cause; (3) protect managements from being sued by shareholders for taking action to defeat a takeover; and (4) allow the company's board to consider the interests of employees, the community, creditors, and other persons in addition to the interests of shareholders.

The amendment was designed to avoid any interference with state laws and regulations concerning banks, utilities and insurance companies—traditionally states have required the approval of a state official for a change in control of these publicly held companies. The amendment was drafted to ensure that they do not interfere with the authority of states to engage in such negotiations and decisions. Finally, the proposed amendment did not interfer with truly locally held or private corporations since securities in these companies do not have to be registered pursuant to Section 12 of the Securities Exchange Act.

(4) The Implications of the CTS Decision for the Current Debate on Corporate Takeovers

After the Supreme Court's decision in *CTS*, the debate regarding tender offer legislation shifted dramatically. Originally, the debate

focused on specific offensive and defensive tactics. At present, the debate has focused upon issues of constitutional law involving the reach of the supremacy and commerce clauses.[99] By upholding the legality of the Indiana Share Control Acquisition statute in *CTS*, the Supreme Court has shifted the efforts of the corporate lobby seeking to gain protection from hostile takeovers from the halls of Congress to the lobbies of state legislatures. The reason for this shift is obvious; corporate constituents find the environment for anti-takeover legislation far more receptive in state houses where state legislators are more responsive to the concerns of local business executives. The success of a single corporate constituent in seeking state anti-takeover legislation is demonstrated by the following list:

State	Company	Date
Arizona	Greyhound	1987
Connecticut	Aetna	1984
Florida	Harcourt Brace Jovanovich	1987
Hawaii	Int'l. Holding Capital Corp.	1986
Kentucky	Ashland Oil	1986
Maryland	Martin Marietta	1983
Massachusetts	Gillette	1987
Minnesota	Dayton-Hudson	1987
Missouri	TWA	1985
New York	CBS	1985
North Carolina	Burlington Industries	1987
Ohio	Goodyear	1986
Oklahoma	Unocal	1985
Pennsylvania	Scott Paper Co	1983
Washington	Boeing	1987
Wisconsin	Heileman Brewing Company	[100] 1987

[100] The irony revealed in this list is that proponents of the Wisconsin anti-takeover statute have urged the Wisconsin State Legislature and the Governor to enact anti-takeover legislation to protect Heileman Brewing Company ("Heileman"). In the early 1980's Heileman was as renown for its raids on other breweries as for the quality of brew.

The debate which has evolved as a relief of the *CTS* decision centers upon the extent to which states may play a legitimate role in regulating contests for corporate control. The debate is not over whether the states can legally play a role, but whether they should play any role in regulating contests for control of national corporations.

The analysis of the *CTS* decision contained in the Report is faulty because it does not recognize the manner in which state anti-takeover statutes such as the control share acquisition statutes and five year freeze out statutes frustrate the Congressional intent of the Williams Act.[101] To comprehend fully the manner in which these state anti-takeover laws directly contravene the purposes and intent of the Williams Act, an examination of the legislative history of that Act is necessary.

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[99] U.S. Const., art. VI, cl. 2. The supremacy clause provides that "[t]his Constitution, and the Laws of the United States which shall be made in Pursuance thereof. . . . shall be the supreme law of the Land. . . . any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

[101] Two other tests are used to determine if state regulation is preempted: (1) whether Congress expressly intended to exclude state regulation; (2) whether Congress implicitly intended to pre-empt state law. Neither is applicable, because Congress permitted state regulation, to the extent not inconsistent with the provisions of federal law, under Sec. 28(a) of the Securities Exchange Act of 1934.

This legislative history of the Williams Act indicates that Congress intended to favor neither target nor bidder in contests for corporate control.[102] Congress specifically rejected the original pro-management legislation introduced by Senator Harrison Williams in 1965.[103] As adopted, the Act was designed so that shareholders would be able to make informed decisions and have adequate time and information to consider offers, without undue advantage accorded to either the bidder or the target.[104]

The Williams Act contains certain timing and disclosure requirements that a bidder must follow. Section 14(d) requires an acquiror to notify the Securities and Exchange Commission, target shareholders, and the target company of a tender offer at its commencement.[105] Among other procedural provisions, the regulations promulgated under the act specify that offers must remain open for a minimum of 20 business days after the commencement of the tender offer.[106]

Between 1986, when the Williams Act was adopted, and 1982, 37 states enacted disclosure laws regulating takeovers. These laws generally required bidders to notify the state of a tender offer and then to wait some specified period before commencing the offer. During that time, the offer was subject to review by a state securities official, usually including a public hearing. These state provisions would delay commencement of the tender offer, perhaps intentionally to permit management to put defensive measures in place.

In 1982, in *Edgar* v. *MITE Corp.*,[107] the Supreme Court ruled 5–4 that the Illinois Business Takeover Act was unconstitutional because it indirectly burdened interstate commerce.[108] The effect of the Supreme Court decision in *MITE* was to invalidate the takeover laws of 36 other states. Some were actually overturned in litigation; others were amended by their states in an attempt to accommodate *MITE;* still others were either repealed or not enforced.

Although it is difficult to read the plurality decision in *MITE* to say much about pre-emption, it did provide some guidelines for determining the outlines of acceptable state regulation of takeovers, First, the state could not delay an offer indefinitely or rule on its merits. And, second, states could not impose statutes that make compliance with both the state law and the Williams Act impossible.[109]

The second item is particularly important for purposes of pre-emption analysis. The underlying purpose of the Williams Act is to

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[102] *See* 113 Cong. Rec. 24.664 (1967) (remarks of Sen. Harrison Williams).

[103] *See.* Edgar v. MITE Corp., 457 U.S. 624, 633 (1982) (quoting Piper v. Chris-Craft Industries Inc., 430 U.S I, 30 (1977)). Sen. Williams' earlier bill, S. 2731, would have required disclosure by a bidder in *advance* of a tender offer.

[104] *Hearings on S. 510 Before the Subcommittee on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 15 (1967) (remarks of SEC Chairman Manuel Cohen).*

[105] 17 U.S.C. 78n(d)(1986). *See also* 17 C.F.R. S. 240.14d-3.

[106] 17 C.F.R. S. 240,14e–1.

[107] 457 U.S. 624(1982).

[108] The *MITE* decision preceded the adoption of Rule 14d-2, which made the conflict between federal law and state law more direct by requiring commencement of the tender offer within five business days of a public annoncement. (Under the various state laws, the pre-commencement period of review with accompanying disclosure and public announcement would be considerably longer than five days, thereby making compliance with Rule 14d-2 impossible.)

[109] *Accord Investor Responsibility Research Center, Can States Stop Corporate Takeovers?* (1987).

protect investors, not incumbent management. Making takeovers more difficult injures investors by depriving them of the opportunity to tender their shares at a market premium; thus, state statutes that presumably frustrate the accomplishment of this Congressional goal would likely be invalid. Moreover, Congress was very careful to avoid favoring either incumbent management or the takeover bidder. Thus, states should not enact laws undermining this policy of neutrality.

The Supreme Court decision in *MITE* prompted state legislatures to adopt so-called "second generation" takeover laws. These new laws came in four varieties. The first, modeled after the Ohio law, was a control-share acquisition law. Acquisitions giving an acquiring party enough stock to cross one of three ownership thresholds—20 percent, 33⅓ percent, and 50 percent—are subject to shareholder approval, and the power to vote such shares is suspended until approved by shareholders. The second type was the fair-price statute, first adopted by Maryland in 1983. The third type was the control-share cash-out law, adopted by Pennsylvania in 1983. The fourth type was the five-year freeze-out fair-price law, first adopted by New York in December 1985.

In 1986, Indiana adopted a control-share acquisition law and a freeze-out fair-price law, largely in response to a threatened takeover of Arvin Industries by the Blezberg family, At first, it appeared that the second generation of state takeover statutes would fare no better than their predecessors. Numerous lower federal court decisions overturned control-share acquisition statutes. So it was the surprise of many that the Supreme Court ruled 6–3 in *CTS* [110] that the Indiana Control Share Acquisition Act did not conflict with the Williams Act nor interfere with interstate commerce.

The majority in *CTS* held that the Indiana law did not conflict with the Williams Act. In doing so, they used the plurality opinion in *MITE* as a guide. That opinion had found three major conflicts between the Illinois statute and the Williams Act: the 20-day precommencement filing, the potential for indefinite delay in completing a hearing on a tender offer, and the state's authority to rule on the merits of an offer.

In *CTS* the Court read the *MITE* plurality opinion to say that the Illinois takeover statute operated to favor management against bidders, to the detriment of shareholders. By contrast, the Court concluded, the Indiana statute protected independent shareholders against both management and bidders in contests for corporate control.

In fact, the majority concluded that the Indiana law actually furthered the federal policy of investor protection by protecting shareholders from coercion in the face of a tender offer. Since independent shareholders often accepted a tender offer rather than risk having to sell at a depressed share price after the offer is closed, the Court concluded that if independent shareholders were able to act *collectively,* they would not be coerced into selling their shares.

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[110] 107 S. Ct. at 1637.

The Court also found that the Indiana statute avoided the problems identified in the *MITE* plurality opinion. Specifically, the Court found that the Indiana law favored neither management nor the bidder, did not impose an indefinite delay on tender offers, and did not allow the state to interject its views on the fairness of the offer.

Also significantly, the Court rejected the argument that the practical effect of the Indiana statute is to delay consummation of tender offers until 50 days after commencement of the offer. Justices White, Blackmun, and John Paul Stevens dissented from the majority, concluding that the Indiana law was pre-empted by the Williams Act because it denied *individual* shareholders an opportunity to sell their shares, tilting the balance away from the protection of investors.

The states have wasted little time in acting on the Supreme Court's endorsement in *CTS*. Six states have adopted new or amended takeover statutes in response to actual or threatened takeovers of in-state companies: North Carolina, in response to a tender offer for Burlington Industries by Asher Edelman and Dominion Textile; Minnesota, in response to a threat against the Dayton Hudson Corp. by the Dart Group; Massachusetts, in response to the renewed interest of the Revlon Group and Ronald Perelman in Gillette; Florida, at the behest of Harcourt Brace Jovanovich, responding to a takeover offer by Sir Robert Maxwell; Arizona, in response to a threatened takeover of Greyhound; and Washington, responding to the acquisition of Boeing stock by T. Boone Pickens, Jr.

Three other states—Louisiana, Missouri, and Nevada—have adopted revised anti-takeover statutes, apparently without direct corporate prompting. Six days after deciding *CTS*, the Supreme Court ordered the Court of Appeals to reconsider its decision invalidating the Ohio control-share acquisition law in light of the *CTS* decision. Many more states in the near future will be adopting takeover statutes, some going beyond the Indiana statute in the belief that *CTS* has not set the outer limits of the law.

The most significant development since *CTS* is the preliminary decision by Delaware not to adopt a takeover statute. At present, Delaware is considering a statute that would regulate contests for corporate control. Assuming that Delaware, the state of incorporation of many large public companies, would establish a sufficient nexus between the state's interests and the companies chartered there, the adoption by Delaware of a takeover statute would have far-reaching implications.

It is instructive to look at why Delaware chose not to join the headlong rush into the adoption of an anti-takeover statute. The initial deliberations of the Delaware legislators which failed to result in the immediate passage of anti-takeover legislation are instructive.

First, the Delaware Bar Association Committee ("Delaware Committee") that studied the issue questioned whether the Indiana

statute would accomplish what it was intended to do.[111] If the bidder and management were excluded from shareholder voting, the shareholder vote, according to the Delaware committee, would likely *always* be in favor of accepting the offer. This is because greater proportional emphasis is given to the votes cast by large investors and arbitrageurs who might prefer short-term profits.

Second, the courts might prohibit management from taking defensive actions—the very goal of the extended offering period—during the proxy solicitation required under the statute.

Third, the Delaware Committee was unconvinced that a 50-day waiting period would necessarily discourage tender offers, given the market's traditional creativity in tender-offer matters.

Fourth, the Delaware Committee believed that the Indiana statute might actually encourage, rather than discourage, tender offers. Under the Indiana statute, almost anyone could trigger the statutory stockholder vote. Certainly, this would publicize the company's availability for sale.

Fifth, the Delaware Committee concluded that either Congress or the SEC will likely impose a one-share, one-vote standard on all shares listed on national exchanges or quoted on NASDAQ. A one-share, one-vote rule might pre-empt the provision of the Indiana law that limits the voting rights of control shares.

Although there may be reason to believe that the states should be free to experiment with such issues as these, the initial decision by Delaware not to act in this area and the current exhaustive deliberations over proposed Section 203 to the Delaware Code demonstrate that the states that have acted may have done so in too much haste and with too little regard for the consequences of such protectionist legislation.

In light of the deliberations of the Delaware Committee and the effect of 51 different laws governing takeover transactions (fifty states and one federal), considerations of public policy weigh strongly against state regulation of tender offers and in favor of federal pre-emption of state regulation in this area. First, recent empirical studies suggest that shareholders suffer significant economic losses from the adoption of state takeover laws. Studies by the Federal Trade Commission [112] and the SEC's Office of the Chief Economist [113] found the adoption of the New York and Ohio takeover laws to have decreased share prices of instate companies by up to 3 percent.

This loss may result from several causes. First, a reduction in the number of takeovers may have reduced the opportunity for holders to receive a premium price for shares. Moreover, a statute reducing the *threat* of takeovers can be expected to reduce the accountability of management to shareholders and to encourage management complacency.

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[111] For a discussion of this and other reasons *see*, Black, Why Delaware Is Wary of Anti-Takeover Law, Wall St. J., July 10, 1987, p. 18. For further reasons discussing the potential dangers of the Delaware anti-takeover legislation currently under consideration *see* Letter from SEC Commissioner Joseph Grundfest to David Brown, Secretary, Council of the Corporation Law Section of the Delaware State Bar Association, Dec. 10, 1987 (Letter on file with the Committee).

[112] *See generally* L. Schumann, *State Regulation of Takeovers and Shareholder Wealth* (March 1987).

[113] *See generally* Office of the Chief Economist, SEC, *Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers* (May 18, 1987).

Second, in an era when capital markets are becoming increasingly international, there is an even greater need for uniformity through federal regulation.[114] A centralized federal regulation of corporate control contests of corporations which have securities trading in national and international markets provides a better and more efficient regulatory framework than 50 separate state statutes. Such a fragmentary tender-offer regulatory system could create uncertainty, inconsistency, and confusion in our capital markets, thereby impairing the national economy. The law should be moving *toward* uniformity, not away from it.

Third, when the U.S. securities laws were developed in the 1930's, in the midst of the Great Depression and in response to widespread flagrant misconduct in the securities markets, Congress wisely rejected an intrusive system of regulation, instead choosing to protect investors against abuses with a minimum of interference in the marketplace. Many state statutes go beyond such disclosure and procedural safeguards, undermining Congressional efforts to maintain a level playing field and neutrality in contests for corporate control.

Fourth, balanced tender-offer reform cannot be accomplished without pre-empting state law.[115] It is impossible for Congress to deal meaningfully with tender-offer reform without considering how the reforms it adopts will coincide with the approach that the states will take in this area.[116]

Delaware and other states are reviewing their existing statutes in light of *CTS* to determine how local companies and incumbent management can be better protected. If the states take an overly pro-management approach, then Congress should enact legislation designed to restore the balance between bidders and targets originally established by the authors of the Williams Act.

Fifth, when Congress adopted the securities laws more than 50 years ago, it concluded that control over those markets was too important to be left primarily to the states.[117] Due to the parochial interests that state legislators must consider, it is unreasonable to expect a state legislature to consider the full implications of state laws on national interests. Consequently, during the Senate debate on S. 1323, the shareholder rights amendment should be adopted because it furthers the purposes of the Williams Act and regulates trnasactions and tender offers of intrinsic national interest.

E. THE ROLE OF STATE AND FEDERAL REGULATION IN GOVERNING TAKEOVER ACTIVITY: A REBUTTAL OF THE REPORT'S ANALYSIS OF THE CTS DECISION

As originally introduced, S. 1323 contained a provision entitled "Section 12. Role of State Law ("Section 12"). This provision would

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[114] *Accord Statement of T. Boone Pickens Jr. Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce,* 100th Cong., 1st Sess. 5-6 (July 22, 1987).

[115] *Accord Statement of Robert F. Greenhill Before the Senate Banking, Housing, and Urban Affairs Comm.,* 100th Cong., 1st Sess. 16 (June 24, 1987).

[116] *Statement of Joseph H. Flom Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce,* 100th Cong., 1st Sess. 10 (July 9, 1987).

[117] S. Hrg. 100-183, Regulating Hostile Corporate Takeovers, Statement of Robert F. Greenhill, July 24, 1987, p. 210.

have amended the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*) by adding at the end thereof the following new section:

ROLE OF STATE LAW

SEC. 36. The Congress declares that the internal affairs of governance of corporations shall be subject to regulation by the laws of the State under which such corporation is organized. Nothing contained in section 13 or 14 of this title, or any rules or regulations thereunder, shall be construed to invalidate, impair, or supersede any law enacted by any State regulating the internal affairs of governance or contests for control of any corporation organized under its laws, except where compliance with such law would preclude compliance with the filing, disclosure, procedural, or antifraud requirements of sections 13 and 14 of this title. *Notwithstanding any other provision of this section, nothing contained in sections 13 or 14 of this title or the rules and regulations thereunder shall be construed to invalidate, impair, or supersede any law or regulation limited to the regulation of a banking, insurance, or similar State-regulated corporations or holding companies."* [Emphasis in original.]

During its consideration of Section 12 on September 30, 1987, the Committee rejected this provision. Section 12 was intended to maximize the authority of the individual states to regulate tender offers and contests for corporate control. The provision was also intended to minimize the reach of the Williams Act and restrict the extent to which uniform federal regulation would govern the interstate market for tender offers and contests for corporate control.

The Committee's decision to reject Section 12 signals its unwillingness to expand the scope of state anti-takeover authority at the expense of federal jurisdiction. Had Section 12 become law, federal regulation would have taken a secondary role in the conduct of contests for corporate control. Section 12 would have effectively eliminated the Williams Act as the binding constraint on takeover activity because states would have been empowered to adopt restrictions far more onerous than those imposed by the Williams Act. The rapid pace with which state anti-takeover statutes have recently been adopted, and the vigor with which states are seeking to craft new and more aggressive anti-takeover techniques that test the limits of the law demonstrate the willingness with which the states would accept an invitation to replace the Williams Act with a stifling quilt of antitakeover provisions.

As a practical matter, Section 12 would also have sharply limited the practical authority of the Commission to regulate the conduct of contests for corporate control. The major focus of authority over tender offer activity and contest for corporate control would thus have shifted to the state houses and away from the federal government. The Committee determined that none of these consequences were desirable. Accordingly, the Committee rejected Section 12.

The Committee's decision to reject Section 12 should be construed as being based on the current state of the law as articulated

in *CTS Corp.* v. *Dynamics Corp. of America,*[118] upholding an Indiana antitakeover statute, and *Edgar* v. *MITE Corp.,*[119] striking down an Illinois antitakeover statute. In those two cases, the Supreme Court signaled a willingness to uphold state antitakeover laws that: (1) are carefully crafted to apply only to corporations that have substantial contacts with their chartering state, and (2) rely on a democratic shareholder referendum that does not conflict with the basic principles of the Williams Act. Statutes that unreasonable delay consideration of offers, substitute the state's judgments for the judgment of shareholders or otherwise fundamentally interfere with the operation of the Williams Act or with interstate commerce do not pass muster.

The Report's treatment of the decision in *CTS* is trobling because it gives minimal emphasis to the actual holding of the case. The Report relies on collateral sources and speculation about the course of future litigation to suggest that the current state of the law is consistent with the objectives of Section 12. The Committee's decision to allow the law to remain unchanged in the wake of the *CTS* decision does not support such an interpretation. The Committee's reliance on the law as it stands today is just that—a reliance on the law as written today. It most certainly is not a prediction or suggestion regarding its future evolution.

To the extent that the Report suggests that S. 1323's silence constitutes support for expansive state anti-takeover legislation, the Report actually represents the minority view. The Committee rejected Section 12 and its underlying philosophy. The Committee's rejection cannot be transmuted into an endorsement of speculative theories about how *CTS* would or should be applied in cases yet to be filed as to statutes that have yet to be enacted.

A fundamental tenet of statutory construction is that the Court will not attempt to resolve for Congress issues that Congress has left unresolved. By the same logic, the Report should not attempt to predict the outcome of cases that have yet to be brought before any court. The Report also should not suggest that its interpretation of how *GTX* might be applied in future cases portrays the Committee's desired application of current precedent. This is particularly the case when the Committee has rejected Section 12—a provision that would have directly achieved the objectives that the Report now seeks to accomplish through its unsubstantiated gloss on the Supreme Court's recent *CTS* decision.

This effort to achieve indirectly through legislative history that which was directly rejected when put to a vote before the Committee can only underscore the concern expressed by some commentators and members of the judicial branch over the extent to which legislative history is, or can be, a reliable guide to the intent of Congress and interpretation of statutory language.[120] Judge Patri-

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[118] 107 S. Ct. 1637 (1987).

[119] 457 U.S. 624 (1982).

[120] The report's attempt to describe in 1987 what Congress intended when the Williams Act was adopted in 196[7]-[8] warrants particularly little deference, and requires no response, because "post-enactment statements by legislators of the statute's meaning are generally considered unreliable," particularity when the statements emanate from a Congress sitting two decades after the event. Wald, *infra* note 121, at 797. *See also Consumer Product Safety Comm.* v. *GTE Sylvania, Inc.,* 447 U.S. 102, 117-18 (1980) (The views of a subsequent Congress from a haz-

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cia Wald of the United States Court of Appeals for the District of Columbia Circuit has, for example, questioned the value of certain Congressional reports because they give improvised explanations of the legislation that are uncorroborated by any other record of the process.[121]

The remainder of this section rebuts the Report's analysis of the Supreme Court's holding in *CTS* and describes a substantial and evolving literature that suggests the Committee is wise in its decision not to expand the authority of the states to regulate contests for corporate control.

In *CTS*, the Supreme Court upheld an Indiana anti-takeover statue against allegations that it violated the Commerce Clause and that was preempted by the Williams Act. The statute at issue in *CTS* was carefully drafted to apply only to corporations chartered in Indiana that also have substantial additional contracts with the state. The statute also relies on a shareholder referendum procedure that the Supreme Court viewed as prompt and fair, and therefore not in conflict with the Williams Act.

Indeed, opponents of takeover activity have urged that other states not adopt statutes similar to Indiana's precisely because Indiana-type statutes allow bidders meaningful opportunity to prevail in a contest for corporate control. Thus, in the view of one vocal opponent of takeover activity, the Indiana statute is actually "proraider" because it "trades an extra 25 days before a tender may be closed for a procedures, including a mandatory shareholder meeting, that heavily favors raiders and which will encourage rather than discourage abusive tactics." [122]

As explained below, the Report incorrectly attempts to extrapolate from the Court's decision in *CTS*, which upholds a statute that requires substantial intrastate contacts and utilizes a democratic shareholder referendum that some takeover critics view as "proraider," to infer the legality of state anti-takeover statutes that: (1) rely on more tenuous contacts with the state enacting the anti-takeover law, and (2) impose non-democratic procedures that clearly burden or restrict shareholder rights of self-determination while dramatically increasing management's ability to oppose an unsolicited offer regardless of shareholder preferences.

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ardous basis for inferring the intent of an earlier one.) The majority report's attempt to rewrite history is particularly striking when it cites a 1985 state court decision (*Moran* v. *Household International, Inc.*), 500 A.2d 1346 (Del. 1985) interpreting a state's corporation laws—not the Williams Act—as evidence that the Williams Act did not affect the "powers of incumbent managers with respect to control contests."

[121] *See*, Wald, Some observations on the Use of Legislative History in the 1981 Supreme Court Term, 68 Iowa L. Rev 19(1983). *See also INS* v. *Cardoza-Fonseca*, 107 S.Ct. 1207, 1224 (1987) (Scalia, J., concurring in the judgment); *Hirschev* v. *FERC*, 777 F.2d 1, 8 (D.C. Cir. 1985) (Scalia, J., concurring); A Scalia, "Speech on Use of Legislative History," as quoted in D.A. Farber & P.P. Frickey, *Legislative Intent and Public Choice*, Stanford Law School, John M. Olin Program in Law and Economics, Working Paper No. 39 (Nov. 1987), at 29–30; *Natural Resources Defense Council* v. *EPA*, 822 F.2d 104, 113 (D.C. Cir. 1987); *Wallace* v. *Christensen*, 802 F.2d 1539, 1559–60 (9th Cir. 1986) (Kozinski, J., concurring in the judgment); Dickerson, *Statutory Interpretation: Dipping into Legislative History*, 11 Hofstra L. Rev. 1125 (1983) (Id.) ["Perhaps even more worrisome is the fear that judicial interpretation of a statute will be skewed by carefully strategized legislative history planted just for that purpose," as is the obvious case here. Farber & Frickey, *supra*, at 21, citing Wasby, *Legislative Materials as an Aid to Statutory Interpretation: A Caveat*, 12 J. Pub. L. 262, 267 (1963).]

[122] M. Lipton, Memorandum to Clients of Wachtell, Lipton, Rosen & Katz, *State Antitakeover Statutes*, June 4, 1987.

The Indiana statute applies only to "issuing public corporations." These corporations must be chartered in Indiana and: (1) have one hundred or more shareholders; and (2) have their principal place of business, principal office, or substantial assets in Indiana; and (3) have either more than ten percent of their shareholders resident in Indiana, or more than ten percent of their shares owned by Indiana residents, or at least 10,000 shareholders resident in Indiana.[123] As the Supreme Court observed, "these thresholds are much higher than the 5% threshold acquisition requirements that brings a tender offer under the coverage of the Williams Act. *See* 15 U.S.C. S.78n(d)(1)." [124]

The statute would therefore not regulate a contest for control of a corporation that was chartered in Indiana but had no other substantial contacts with the state. Nor would it regulate a contest for control of a corporation that had substantial facilities within the state but was not chartered there. The statute applies only to corporations that are organized under Indiana law and have a substantial presence in the state. It therefore cannot be inferred from the holding in *CTS* that the Court would approve state anti-takeover statutes that attempt to control takeovers involving corporations that have more tenuous contacts with a jurisdiction. In particular, the holding in *CTS* does not stand for the proposition that a state can lower takeover contests for corporations that are not chartered by the state but that have substantial state contacts. The holding in *CTS* similarly does not support the proposition that a state can apply its anti-takeover laws to all corporations chartered by the state, without regard to other contacts measured, for example, by the presence of local shareholders or business operations.

The Indiana statute does not divest shareholders of the right to determine whether to tender their shares into an offer opposed by management. The statute also does not grant to management the right to place substantial impediments in the path of an unsolicited bid. Instead, the statute increases the emphasis on shareholder self-determination by allowing shareholders to decide whether a bidder will be permitted to pursue an acquisition proposal. In particular, the statute restricts the right of substantial acquiring shareholders to vote their shares unless they obtain the prior approval of a majority of the corporation's disinterested shareholders. The statute's voting rights restrictions are triggered whenever an acquirer purchases shares that, but for the operation of the statute, would give him voting rights in excess of 20%, 33⅓%, or 50%. In order to exercise voting rights in excess of any of these thresholds, the acquiring shareholder must obtain the approval of a majority of the disinterested stockholders in a shareholder referendum. The acquiring shareholders and the corporation's officers and directors are not disinterested for purposes of the referendum. They are therefore not permitted to participate in the referendum on the acquirer's right to vote shares acquired in excess of a threshold.

As the Court observed, this referendum procedure does not short circuit the Williams Act's reliance on full disclosure and shareholder self-determination. Instead, "[t]he practical effect of this require-

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[123] Indiana Bus. Corp. Law., Ind. Code § 23-1-42-4(a).
[124] 107 S.Ct. at 1641, n.1.

ment is to condition acquisition of control of a corporation on approval of a majority of the pre-existing disinterested shareholders." [125]

"The shareholders decide whether to confer rights on the control shares at the next regularly scheduled meeting of the shareholders, or at a specially scheduled meeting."[126] The statute gives the acquirer the right to demand a special meeting within 50 days if the acquirer agrees to pay the expenses of the meeting and files an information statement describing, *inter alia,* the identity of the acquiring person and the terms and extent of the proposed acquisition.[127] As the Court observed, this maximum 50-day waiting period is not unreasonable and is within the "60-day maximum period Congress established for tender offers in 15 U.S.C. S.78n(d)(5)."[128] Thus, the Court concluded it "cannot say that a delay within that Congressionally determined period is unreasonable."[129] Statutes with longer waiting periods, or indefinite delays, as in *MITE,* are therefore not covered by the holding in *CTS.*

The central theme in the Court's preemption analysis is that "the Indiana Act operates on the assumption, implicit in the williams Act, that independent shareholders faced with tender offers often are at a disadvantage" because offers can have "coercive aspects."[130] The referendum mechanism required by the Indiana statute "does not give either management or the offeror an advantage in communicating with the shareholders about the impending offer [and] does not impose an indefinite delay. . . ."[131] Instead, the Act "allows *shareholders* to evaluate the fairness of the offer collectively."[132]

A statute that relies on shareholder self-determination to resolve a collective action problem without imposing unreasonable burdens on a potential bidder, and without granting to management or the acquirer an advantage in the referendum process, is not preempted by the Williams Act because "the regulatory conditions that [such an] Act places on tender offers are consistent with text and the purposes of the Williams Act."[133] Statutes that do not allow shareholders collectively to evaluate the fairness of the offer, but instead attempt to deter the offer from being made in the first instance, or attempt to place the shareholders in a disadvantageous position *vis a vis* the competing interests of the corporate management or of an unsolicited bidder, may not be consistent with the text and purpose of the Williams Act and may not pass muster under the Court's preemption analysis in *CTS.*

The Court's Commerce Clause analysis evaluated four distinct considerations. First, the Court considered whether the statute discriminates against interstate commerce. Because the statute has identical effects on tender offers "whether or not the offeror is a

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[125] 107 S.Ct. at 1641.
[126] 107 S.Ct. at 1642.
[127] 107 S.Ct. at 1642, n.4.
[128] 107 S.Ct. at 1647.
[129] 107 S.Ct. at 1647.
[130] 107 S.Ct. at 1646.
[131] 107 S.Ct. at 1646.
[132] 107 S.Ct. at 1646. [Emphasis in original.]
[133] 107 S.Ct. at 1648.

domiciliary or resident of Indiana,"[134] the Court rejected the argument that the statute discriminates against interstate commerce.

Second, the Court considered whether the statute could subject corporations to inconsistent regulatory requirements. Because the statute applies to some corporations chartered in Indiana, and because corporations are chartered in only one jurisdiction, "the Indiana Act poses no such problem."[135]

Third, the court considered whether the burdens imposed by the statute impermissibly hinder the interstate market for tender offers. The Court rejected this argument because it found that the referendum process at the heart of the Indiana statute was fully consistent with the state's "interest in promoting stable relationships among parties involved in the corporations it charters, as well as ensuring that investors in such corporations have an effective voice in corporate affairs."[136] Whatever the burdens created "by allowing shareholders collectively to determine whether the takeover is advantageous"[137] those burdens that are so unrelated to the state's legitimate interests in protecting shareholders that they cause the statutes to violate the Commerce Clause.

Finally, the Court rejected the argument that Indiana's statute was unconstitutional because it would limit the number of successful tender offers. The Court rejected this analysis, observing that "there is little evidence that this will occur."[138] In the Court's view, the statute only "provides regulatory procedures designed for the better protection of the corporation's shareholders" through a referendum that avoids collective action problems.[139]

Statutes that impose more onerous restrictions on tender offer activity, discriminate against out-of-state offerors, permit potentially inconsistent regulatory burdens, or fail to promote a legitimate state interest in allowing shareholders to express their collective preferences, would not necessarily be found constitutional under *CTS*. It is worth emphasizing the fact that the Indiana statute at issue in *CTS* was a fundamentally democratic statute that protected shareholders' rights to express the will free of coercive influences from bidders and defending managements. State statutes that are not so democratic, or even-handed, or temperate in their approach to takeover regulation cannot rely directly on the Court's holding in *CTS* as evidence of their legality.

The Committee's decision to reject Section 12 would seem to find support in a substantial and evolving literature that questions whether the states are better suited than the federal government to regulate tender offers and other contests for corporate control. This literature has its roots in the longstanding debate over whether state chartering leads to a "race to the bottom" or beneficial competition that promotes efficiency and flexibility. However, as explained below, one need not be a supporter of federal corporate chartering—a contentious and problematic proposition—in order to

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[134] 107 S.Ct. at 1649.
[135] 107 S.Ct. at 1649.
[136] 107 S.Ct. at 1651.
[137] 107 S.Ct. at 1651.
[138] 107 S.Ct. at 1652.
[139] 107 S.Ct. at 1652.

appreciate the difficulties raised by state regulation of contests for corporate control.[140]

Supporters of state chartering have argued that state control over the corporate chartering process is beneficial because it promotes valuable competition and diversity among jurisdictions.[141] Under this view, state corporation law is the socially beneficial outcome of a regulatory regime that promotes efficient corporate decisionmaking and provides competence and predictability in resolving corporate disputes. Proponents of this view believe that a federal corporation law is undesirable because it would preclude healthy competition among the states.[142]

Opponents of state chartering allege that state control over corporate chartering fosters an undesirable "race to the bottom" in which states aggressively cater to management interests at the expense of stockholders and other corporate constituencies.[143] Under this view, a state's position as a corporate domicile is the result of its willingness to accede to management desires at the expense of stockholders and other social interests. Thus, opponents of state chartering contend that federal chartering of large public companies may thus be desirable.

More recently, a third perspective has emerged. This perspective, which has particular relevance to the anti-takeover debate, suggests that local interest groups can manipulate state legislative decisions so as to further those groups' private objectives.[144] A state's decision regarding anti-takeover legislation can thus be the result of a complex interaction between the objectives or large, locally influential corporations, local bar groups, and other constituencies that are not representative of the state's broader interests as much as they are influential and highly motivated to express themselves on the issue of takeover regulation.[145] Under these circumstances, states may be motivated to adopt statutes that impose costs on shareholders, and studies have found statistically significant stockholder losses in response to a state's decision to adopt anti-takeover legislation.[146] Some commentators thus argue that a state's incentive to maintain local revenues and to preserve intrastate social and economic interests may govern its decision to adopt anti-take-

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[140] Some commentators see a paradox in this situation. As Professor Romano has observed, "Takeovers are of particular interest because they generate a puzzle for the state competition literature. Some commentators who contend that state competition produces laws that benefit shareholders have also maintained that mechanisms which facilitate management's efforts to thwart hostile bids, such as actions codified by takeover statutes, are not in the shareholders' interest and should be banned." Romano, *The State Competition Debate*, *supra* note 16, at 726.

[141] *See, e.g.*, Winter, *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. Rev. 913 (1982); Easterbrook, *Manager's Discretion and Investor's Welfare: Theories and Evidence*, 9 Del. J. Corp. L. 540 (1984).

[142] *See, e.g.*, Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. Bus. 59 (1980); Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 Yale J.L. Econ. & Org. 225 (1985).

[143] *See, e.g.*, Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974).

[144] *See* note 16 *supra*.

[145] *Id.*

[146] *See, e.g.*, Office of the Chief Economist of the SEC ("OCE"), *Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers* (May 18, 1987); Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Effects of New York's 1985 Takeover Statute* (Federal Trade Commission, 1987).

over legislation regardless of adverse consequences to stockholders or larger social or economic constituencies.[147]

Indeed, certain state anti-takeover statutes are prototypical examples of efforts by states to improve local conditions by imposing costs on residents of other states. These clear externality effects can distinguish anti-takeover statutes from other areas of local concern that impose little or no extraterritorial costs *e.g.*, police power and education concerns.[148]

State corporation codes generally prior board approval before stockholders can vote to reincorporate in a new jurisdiction. To the extent that takeover activity reflects an underlying principal-agent problem within the corporation, a management that is vulnerable to a takeover because it has refused to maximize shareholder values is unlikely to propose a reincorporation that would make a takeover more likely, even if the reincorporation clearly enhances stockholder welfare. This fact sharply reduces the efficacy of interstate migration as a means of disciplining states that adopt sub-optimal anti-takeover statutes.[149] Accordingly, the process of competition among the states, which may have been quite beneficial in situations where shareholders and management interests are in harmony, does not necessarily lead to beneficial results when there is a dispute within the corporation and the dissenting constituency—shareholders or managers—cannot prevail upon the corporation to reincorporate in a jurisdiction that allows the dispute to be resolved.

Recent empirical research regarding the market for corporate charters is consistent with the market process described above. At the same time, that research supports the notion that competition among the states leads to a "climb to the top," not a "race to the bottom." Therefore, one need not abandon faith in state chartering and become a devotee of a federal corporations code in order to raise concern over state anti-takeover laws.

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[147] *See, e.g.*, Macey & Miller, *supra* note 16.

[148] *See* R. Gilson, *The Law and Finance of Corporate Acquisitions* 1060 (1986) ("Target companies are always 'local' in the states in which their headquarters are located or in which they have substantial facilities. A takeover, with the potential for management restructuring, the relocation of executives, plant closings, the loss of jobs and the like, pose an obvious threat to local interests. From this perspective, state legislation that strengthens target management's hand in a hostile tender offer makes perfect sense: The interests of target management and the state correspond even if those of target management and target shareholders may not. A state statute that reduces the likelihood of takeovers makes shareholders as a class worse off, and likely also has a negative impact on the national economy by reducing managerial incentives to maximize the efficiency of their enterprises. From the perspective of the state, however, its share of these costs would not outweigh its shares of the benefits. The costs—to shareholders and the overall economy—are shared across the nation; the benefits, in contrast, are entirely local."); Levmore, *Interstate Exploitation and Judicial Intervention*, 69 Va. L. Rev. 563, 622-24 (1983). *Cf.* Rose-Ackerman, *Does Federalism Matter? Political Choice in a Federal Republic*, 89 J. Polit. Econ. 152 (1981) (social choice approach to state-federal conflict).

For a clear and current example of this externality, consider Sir James Goldsmith's attempt to acquire Goodyear, a large Ohio corporation. Ohio has an incentive to protect its local interest in maintaining Goodyear's plants and headquarters in Ohio. It can do so by imposing substantial costs on Goodyear's stockholders, most of whom are not Ohio residents, and some of whom are now clearly foreigners. One need not take any position, pro or con, with regard to the merits of the proposed Goodyear takeover to see the obvious potential to export costs without regard to net social welfare.

[149] Corporations that are most likely to benefit from a contest for control are therefore the very corporations least likely to repond to an antitakeover statute by moving to a more permissible jurisdiction. This places stockholders in a corporate "Catch-22" for which competition among the states provides no effective remedy.

In light of the incentives that individual states may have to adopt measures that are locally beneficial but harmful in the aggregate, and in light of the evidence that state anti-takeover statutes may impose substantial costs, the decision to reject Section 12 and rely on the continuing evolution of the case law, as articulated in the Supreme Court's holding in *CTS*, represents a balanced and temperate approach to a difficult and continuing problem.

F. GREENMAIL, GOLDEN PARACHUTES AND POISON PILLS

The original provisions of S. 1323 contained provisions designed to restrict the payment of greenmail, the award of golden parachute agreements and the use of poison pills. With the support of Senator Proxmire, these provisions were stricken from the legislation. Attempts by Senators Gramm and Armstrong to restore the golden parachute and poison pill provisions were defeated on a 12-8 vote. These provisions should be included in the legislation because they are designed to protect shareholders from the unilateral actions of incumbent managers.

S. 1323 contained an anti-greemail provision which prohibited an issuer from buying back its securities at a price above the market value from any person holding more than 3 percent of those securities if that person held the stock for less than 6 months. Exceptions to this rule were permitted if the stock subject to greenmail was purchased pursuant to a tender offer open to all shareholders or the repurchase constituting greenmail was approved by a majority of the issuer's shareholders. Critics of greenmail find this management practice objectionable because it derails the auction process, and thwarts equal protection of shareholder participation in the control premium. The purpose of the proposed amendment was to restore the original language of S. 1323 to limit greenmail payments except as specifically permitted by the issuer's shareholders or unless the payment was made pursuant to an offer open to all shareholders.[150]

In recent years, the senior managements of takeover targets have, during the pendency of a takeover bid, resorted to awarding themselves lucrative compensation agreements commonly referred to as golden parachutes. Golden parachute agreements generally give a target's officers the right to substantial severance payments, without shareholder approval, in the event of their termination following a change in control of the target. The amendment which was defeated during the Committee's consideration of S. 1323 sought to restore the original golden parachute restrictions contained in S. 1323. The amendment prohibited the adoption of golden parachute agreements during the pendency of a tender offer unless the Securities and Exchange Commission provided an ex-

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[150] Assuming the Senate determines to adopt an anti-greenmail provision it should do so in a manner that does not improperly impede non-greenmail transactions. In particular, an exemption should be provided for repurchases that are approved by a majority of disinterested stockholders. An exemption also should be available for transactions open to all shareholders on a pro-rata basis (*i.e.*, a self-tender subject to the Williams Act). A further exemption should be considered for transactions that occur at prices no greater than open market prices prevailing two or more business days after the transaction is announced. In these transactions, the greenmailer will be unable to capture a takeover premium attributable to his stock position because the market price will already have discounted the fact of the sale. *See* Gilson, *How to Draft a Prohibition on Greenmail* (working Paper, Oct. 1987).

emption by rule, regulation or order. The effectiveness of any golden parachutes adopted prior to the commencement of a tender offer would not be affected.

Similar treatment was accorded by S. 1323 for those corporations which adopted "poison pill" plans to thwart tender offers. Poison pill plans typically provide for the issuance of stock purchase rights to shareholders that automatically, without any further action by the target, permit such shareholdes to purchase securities of an acquiring company or the issuer in takeover situations not approved by the issuer's board of directors. These rights generally provide for a purchase of those securities at a substantial discount and on terms designed to make the issuer a less attractive takeover candidate. Such plans have generally been adopted without shareholder approval.

The amendment which was defeated during the Committee's consideration of S. 1323 sought to restore the original "poison pill" restrictions contained in S. 1323. The amendment prohibited the adoption of poison pill plans during the pendency of a tender offer unless the SEC provides an exemption by rule, regulation or order. The effectiveness of any poison pill plan adopted prior to the commencement of a tender offer would not be affected.

The need to impose statutory restrictions on greenmail, golden parachutes and poison pills was articulated by Senator Proxmire in his statement accompanying the introduction of S. 1323. In that statement Senator Proxmire observed:

> Yet another way to discourage manipulative raids is to outlaw what's known as greenmail. This is a premium that is paid by the target company to the raider in exchange for calling off the raid. Whether or not the target or the raider is the more blameworthy is unimportant here; what's important is that greenmail must stop. . . .
>
> While manipulative raids must be discouraged, management must not be allowed to entrench itself. The defensive tactic known as the "poison pill," where target firms create new stock to thwart a purchase, is wrong. I propose to ban the adoption of poison pills during a tender offer.
>
> The same for golden parachutes. These are the self-serving bonuses that executives pay themselves if they are ousted. Clearly, the compensation is unrelated to their performance, and simply milks shareholder value.[151]

The need for curbs on the use of greenmail, golden parachutes and poison pills was also articulated by various expert witnesses who testified before the Committee.

For example, David M. Roderick, Chairman of USX Corporation stated, "The quick profits available simply through financial manipulation and legerdemain have created an era of such greed that we are witness to the continuous unfolding of scandalous criminal behavior in pursuit of making a quick killing. I most certainly want government response to eliminate these abuses . . . abuses that are so apparent that I submit legislative action should be taken immediately."[152] Moreover, Chairman and CEO of Universal

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[151] 133 Cong. Rec. S.7596-S.7597, Statement of Senator Proxmire (daily ed. June 4, 1987).
[152] S. Hrg. 100-50 Hostile Takeovers, March 4, 1987, p. 130.

Foods Corporation, John Murray said, "I believe that the Congress should focus its attention on the unsolicited tender offer attempts. Congress should recognize the lack of logic, even madness, in case law which suggests a company is expected to participate in its loss of independence (negotiating for a higher price, seeking white knights, etc.) just because some unwelcome purchaser has indicated they want to buy the company." [153] Perhaps, Harrison J. Goldin, New York City Comptroller was most concise on these issues when he stated, "We are of like mind about the need for regulation of poison pills, golden parachutes and greenmail. We, however, would go further, prohibiting them altogether without the approval of a majority of disinterested shareholders." [154]

During the Committee's hearings on S. 1323, the SEC argued that defensive tactics such as golden parachutes, posion pills and greenmail are abuses that are best remedied by state legislatures.[155] However, the shareholder abuses attendant to these practices have gone unnoticed in state legislators' rush to enact anti-takeover legislation. In their legislative assault on corporate raiders, corporate executives have failed to campaign with equal vigor for prohibitions against tactics that injure shareholders. Therefore, the original restrictions of S. 1323 which limit the use of greenmail payments, poison pills and golden parachutes should be reinstated.

PART III

A. INTRODUCTION

The stated purpose of S. 1323 was not to upset the balance between bidders and targets or the shareholders protections established in the Williams Act. In the introductory statement accompanying S. 1323, Senator Proxmire recommends that "tender offers themselves should be neither encouraged by law; egregious defenses as well as coercive takeover tactics should be limited. . . . [The] management of publicly held companies should not be entrenched. Shareholders should be able to remove incompetent managers."[156] Regrettably, S. 1323 in its current form fails to accomplish these laudable objectives. The provisions of S. 1323 discussed below demonstrate the manner in which tender offers will be discouraged by law and increase management entrenchment by making it more difficult for shareholders to remove inefficient management. Finally, neither the legislative history or the Report accompanying S. 1323 provide adequate justification for the specific provisions of that legislation which are described in Part III.

B. SECTION 3

(1) Section 3(b)

The 30-day look-back reporting provision of section 3(b) is both unworkable and unnecessary. This provision which amends Section 13(d) of the Securities and Exchange Act applies to all transactions covered by Section 13(d) and *not* just to acquisitions made pursuant

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[153] *Id.* at 140.
[154] S. Hrg. 100-183, Regulating Hostile Corporate Takeovers, June 25, 1987, p. 350.
[155] S. Hrg. 100-183, Regulating Hostile Corporate Takeovers, p. 107.
[156] 133 Cong. Rec. S7596-S7597 (daily ed. June 4, 1987) (statement of Senator Proxmire).

to a takeover. Therefore, this provision requires that in all transactions covered by Section 13(d), the disclosure of all communications, including the dates thereof, within the prior 30 days with anyone who acquired securities "in connection with" such communications is unnecessary and burdensome. This provision is vague and the Report provides no guidance with regard to the meaning of the phrase which is contained in this provision "in connection with".

Further, it is unduly burdensome. This provision would impose substantial paperwork and recordkeeping obligations upon securities traders, in order to collect information that no one wants. It requires investors to keep records concerning all of their communications—whether or not they are seeking control of any company. The deterrent against block ownership will be enormous. This section could have the unintended effect of chilling the free flow of legitimate investment information on Wall Street and between corporations and anlysts.

Finally, the requirements of section 3(b) are only useful if the communications ultimately result in the information of a group as defined in S. 1323. If the communication does not result in the actual information of a group, or if it does not result in a business relationship that would otherwise be subject to disclosure, it is unclear why the fact of the communication is material and should be subject to disclosure. If the communication does result in the formation of a group, then the reporting obligations triggered by Section 14 of the Exchange Act adequately address such an event. The SEC has testified that this provision would "impose difficult, if not impossible burdens on filers of Schedule 13D" and that the disclosure would not be useful for enforcement purposes.[157] Indeed, one suspects that the true purpose of the legislation is to increase transaction costs for bidders and securities traders. The Report does not and cannot explain why Congress would want to require detailed records that would be useless to other investors and that the SEC does not need.

(2) Sections 3(c) and 3(e)

The additional disclosures required by these provisions of S. 1323 amend Section 13(d) of the Exchange Act and therefore apply to all acquisitions of 5% or more of a company's share and not to acquisitions involving takeovers. In a tender offer situation the disclosure requirements of Section 14(d) of the Securities Exchange Act are adequate. One must question the utility of requiring so much information beyond current disclosure requirements.

With regard to corporate takeovers, the information that the SEC requires to be disclosed in a Schedule 14D filing is very similar to the statutory requirements of Section 3 of S. 1323.

Section 14(d) already requires disclosure of:

(a) information about the acquirer's background, identity, residence and citizenship;

(b) the source and amount of the funds;

(c) the purposes of the purchases and prospective purchases;

(d) the number of shares beneficially owned; and

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[157] S. Hrg. 100-183, Regulating Hostile Corporate Takeovers at 91-92.

(e) information about contracts and arrangements to purchase the securities.

If additional disclosure under Section 13(d) is required, then this is better accomplished through the more flexible means of SEC rulemaking than through the relatively inflexible means of a statute. This point was stressed by Acting SEC Chairman Charles C. Cox in opposing this provision in testimony before the Committee.

> Any additional disclosure requirements should be effected through the rulemaking process. Through rulemaking, the Commission can respond flexibly to the continually changing takeover environment.[158]

In its submission to the Committee, the American Bar Association (ABA) questioned the utility of disclosing the coss associated with an acquisition that triggers a Schedule 13D filing since such an acquisition is not made pursuant to a takeover.

> We also fail to see the merit in the bill's proposal to increase the scope of disclosure of financing for 13D Statements to include descriptions of all financing agreements, fees paid and plans for repayment. In most cases, such disclosure would not be material to the investing public. Should the 13D filer seek to acquire the issue in a tender offer or merger such disclosure is material and currently required.[159]

This provision does not enhance investor protection, it covers all securities transactions covered by Section 13(d) and not those made pursuant to takeovers, and information provided pursuant to this section is of little use to the SEC. This provision has an adverse impact on the day-to-day operation of the securities markets and only incidentally effects corporate takeover activity.

(3) Section 3(d)

This provision amends existing section 13(d)(1)(C) of the Exchange Act to state whether the investment purpose "is to acquire, or influence the control of the issuer" of "is solely for investment, without any purpose or effect of changing or influencing the control of the issuer. . . ." The provision requiring a person to designate whether his intent is to "influence" the control of a company or "solely" for investment should be eliminated. It can be used to add confusion to the disclosure process and help conceal an investor's true intent. The concept of "influencing" management is so overbroad and vague that it would apply to every investor who intends to vote his shares without blindly following management's recommendations. The change of intent problem is more adequately addressed in the civil penalties provisions of Section 6 for violations of Sections 13 (d), (f), and (g).

Section 3(d) will not necessarily aide in the detection of insider trading because inside traders will never acquire enough of a stock to trigger a filing. Further, if inside traders did, it is doubtful that they would identify those people with whom they communicated with over the previous 30 days.

Finally, the combined effects of Sections 3 (b), (c), (d), and (e) will have an adverse impact on the day to day operation of the securi-

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[158] *Id.*
[159] *Id.* at 515.

ties markets. The problem with the combined impact of the 30 day communication requirements and change of intent language is when you inadvertently or unexpectedly hit the 5% threshold, an acquiror will have to reconstruct all oral and written communications and submit these materials to the SEC.

Rather than risk this, most firms and institutional investors will be compelled to keep detailed information on every major securities transaction they and their clients are involved in because, at the time they execute a transaction, they may not know that they will be part of a takeover fight.

Further, the type of disclosure equaling anything short of "for investment purposes only" can lead to speculation. For example, an investor acquires 5% of an issuer's stock and discloses this acquisition. The stock price runs up and rumors circulate regarding a possible takeover. The investor sells a significant amount, if not all, of the 5%. The federal securities laws do not require any notification of this sell off. The net effect of these provisions would be to artificially move the market and could unintentionally "put a company in play" and thereby play into hands of speculators.

C. SECTION 5—CHANGE OF INTENT; SIXTY DAY FREEZE

Perhaps the most problematic provision of S. 1323 is Section 5(a). Section 5(a) contains a substantive prohibition against purchasing shares for 60 days after a person changes his or her investment intent from "solely for investment" to "influencing control." This provision exceeds the scope of the historic role of Section 13(d) as a disclosure statute.

False declarations of an investment intent by corporate "raiders" and others are already subject to SEC enforcement under existing Section 13(d). Such actions have been brought and will continue to be brought when the facts warrant. However, there is no evidence that most changes from investment to active intent show that the investor was originally lying about his intent. Further, the increased civil penalty provisions of section 6 of S. 1323 provide adequate deterrents against those speculators who formally notify the SEC of a change in their investment intent once they begin a tender offer.

Although SEC opposed this provision, the most articulate explanation of the perils presented by Section 5(a) were contained in the ABA's submission to the Committee. The ABA submission commented on the combined adverse impact of the requirements of Section 3(d) and Section 5(a) of S. 1323.

> S. 1323 requires 13D filers would also be required to specify whether their purpose in acquiring shares is (i) to influence or acquire control of the issuer or (ii) only for investment. If a person specifies investment intent, such person may not acquire shares of the issuer by tender offer until six months after the filing of an amendment disclosing that the purpose of such filer is to influence or acquire control. This six month prohibition [S. 1323 was amended at markup to reduce this period to 60 days; however the ABA's criticisms are still valid] constitutes overkill. We fail to see how the public and shareholders are served by requiring a six month moratorium because of a

change of intent. In many cases 13D filers may not know at the time of an initial filing whether their intent is investment only. A filer may be uncertain or change his mind because of changing conditions or otherwise. The law should not preclude free choice. Many otherwise passive investors may elect to specify possible control intent in order to avoid the six month delay should circumstances change and the investor later desires to seek or influence control. This, in turn, could be misleading to the market. If such a choice is required, we would suggest an approach similar to that utilized by the SEC in effecting changes from filing a 13G Statement to filing a 13D Statement. Current provisions prohibit 13G filers from voting, acquiring or disposing of shares for a ten day period afte they have a change of intent and file a 13D Statement. We believe this is within the SEC's current rulemaking authority and, therefore, Congress need not deal with this item specifically.[160]

Another obvious and perverse effect is to make investors much less likely to disclose investment intent, whatever their true intent, thus undercutting the disclosure value of the Schedule 13D. Investors filing Schedule 13D's will have a strong incentive to delcare a control intent even if they are purchasing for investment, as protection against the possibility that they may change their minds in the future and thereafter want to purchase more shares without waiting 60 days. The provision's greatest effect would be on truthful investors who honestly declare an investment intent and thereafter change their minds. More devious persons will declare a control intent in the first place, whether they intend to acquire control or they intend to drive the price of a stock up and then sell out.

Although Section 5(a) contains an exception for "material change of circumstances", this provision is vague and likely to lead to litigation between issuers and major shareholders. This enriches lawyers and harms shareholders.

The following questions which arise under the 60 day freeze provision demonstrate the problems created by a sixty or a six day freeze:

(1) What purpose does the freeze serve other than to disrupt the free flow and liquidity of the capital markets?

(2) Does the freeze also apply to those situations where a purchase may wish to liquidate its holding after an announcement?

(3) How does the freeze also apply to options or other derivative securities? What effect does this have on the arbitrage profits that can be made through program trading?

(4) Would this freeze also apply to securities listed on foreign exchanges?

(5) Would the freeze be lifted if a counter tender offer is made by management or a third party? Why should the freeze apply at all if the frozen purchaser is interested in paying a premium to those shareholders who wish to tender? (In essence, this is a federal statutory preemption of a shareholder's

[160] *Id.* At 515–516.

right to tender and another shareholder's, a significant shareholder at that, right to purchase.)

Neither the legislative history or Report accompanying S. 1323 provides answers to these questions. Thus, the 60 day freeze provision should be rejected because: it impairs the liquidity of securities markets; everyone will state that their initial investment purpose is not "for investment purposes only," and this would result in everyone disclosing that they are a potential acquiror to avoid the freeze regardless of their actual intent at that point in time; it could result in more speculations because Arabs will purchase and wait on the sidelines as management tries to line up another acquiror or while they wait out the final days of the freeze; and the freeze encumbers the rights of a major shareholder.

Section 5(a) also contains a provision requiring announcements made pursuant to Sections 13(d)(1) and 13(d)(2) of the Exchange Act to be made to one or more nationally recognized financial news service. This provision suggests that the Commission will have to certify organizations as "nationally recognized financial news services." This will certainly raise press sensitivities over licensing and regulation of media sources and will potentially involve the Commission in a difficult standard-setting exercise.

Finally the SEC opposes this provision. The SEC believes this public announcement of an amendment creates the following problems:

> (a) The sheer volume of such amendments would be unduly burdensome since these amendments would be made public in any acquisition (not just tender offers) requiring a 13D filing—especially if the threshold were lowered to 3% as originally required by S. 1323;
>
> (b) This would be a novel approach to SEC disclosure—disclosure by public announcement; the SEC does not believe amendments should be made by public announcement, rather they should be made by filings; and
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> (c) The contents and accuracy of the public announcement may be the source of litigation. This is problematic because the "public announcer" has no control of the accuracy of the media's coverage of the announcement. This would result in the unintentional spread of misleading and speculative information.[161]

Section 5 also contains a definition of the term "group" which has aroused SEC and ABA opposition. The SEC argued that:

> Existing Commission rules are sufficiently broad to address arrangements or understandings that are not written or express. Rule 13d-5 covers those situations in which 2 or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of securities. Knowingly parallel conduct already constitutes evidence of an agreement under section 13d. For example, the courts have held that the fact that an investor knows that he is acting through his broker, along with other clients of that broker, to form a block for the

[161] *Id.* at 92-95.

benefit of the entire group, is evidence that all clients were acting together.[162]

The ABA submission also questioned the need for the definition of the term "group" noting that the courts have done an adequate job of discerning groups:

> We believe the existing definition of "person" and "group," as interpreted by the courts, is sufficient to pick up any arrangements (however formal) to act in concert to buy or to vote shares. As the District Court put it in the recent *Champion Parts Rebuilders* case, a court will not "play ostrich in the face of strong circumstantial evidence," such as parallel share purchasing in a correlated manner, demonstrating the existence of a section 13(d) group. *Champion Parts Rebuilders, Inc.* v. *Corpricer,* No. 86C8906. (N.D. Ill. April 9, 1987). *See also e.g., Spinner Corp.* v. *Princeville Development Corp.,* Fed. Sec. L. Rep. Sect. 93,658 (D. Hawaii 1986) (shareholders were acting as a group and should have filed Schedule 13D); *Citizen First Bancorp, Inc.* v. *Harrold,* Fed. Sec. L. Rep. Sect. 99,412 (W.D. Ky. 1983) (dissidents were a group, it "would require an unbecoming degree of naivete to believe that their activities were mere coincidences," not the result of group agreement).[163]

D. SECTION 6—CIVIL LIABILITY

The Report does not make it clear that the civil liabilities provided by Section 6(a) can only be brought by the Securities and Exchange Commission. Section 6 was not intended to create any express or implied private rights of action. S. 1323 as originally introduced contained provisions which granted private rights of action for "any person aggrieved" by a violation of Section 7 or sections 13 (d), (f), and (g) of The Exchange Act. This provision was deleted by a unanimous vote of the Committee.

However, Section 6(b) contains provisions which provide the SEC with specific injunctive relief. Both S. 1323 or the Report are silent on whether the injunctive relief provided in Section 6(b) is available to private litigants. Section 6(b) does not create express or implied private rights of action.

In opposing this provision, the SEC testified that "the sanctions and remedies available through the equitable jurisdiction of the courts are largely adequate." The provisions requiring increased civil money penalties are acceptable to the SEC. However, those provisions specifying the SEC's injunctive authority could prove problematic to the SEC's general enforcement efforts.

S. 1323 would grant the SEC and private litigants the ability to seek specific injunctive actions that would: (1) prevent a shareholder from voting securities; (2) require a divestiture of such securities; and (3) prohibit the acquisition of further shares pursuant to a tender offer or other acquisition designed to influence control.

The SEC and private litigants can already seek these forms of equitable or injunctive relief. The SEC also is concerned that, by combining civil penalties with the injunctive relief provisions as S.

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[162] *Id.* at 93.
[163] *Id.* at 517.

1323 does, the Commissioner's enforcement efforts may be hampered. In a recent decision,[164] defendants subject to civil damages were awarded the right to a jury trial. S. 1323 therefore may compel the SEC to combine both the civil damage provisions of S. 1323 and the specific equitable remedies in the same proceeding. This could delay the SEC's ability to seek immediate equitable relief if the defendant exercises his right to a jury trial.

Currently, the SEC seeks the equitable remedies specified in S. 1323 under ancillary jurisdiction pursuant to injunctive actions. The SEC contends that it currently possesses this equitable relief provided by this section in other provisions of the federal securities laws. To specifically enumerate the remedies in one section may create the negative inference that the SEC lacks these same remedies under other provisions of the federal securities laws where they are not specified.

Section 6(b) was not intended and should not be construed as providing private parties, including target company managers, the right to seek injunctive relief and damages. The effect of this provision would clog the courts with abusive strike suits. Section 6 would give a variety of parties the means to thwart legitimate takeover bids by holding them hostage to the courts for months or even years. Without a grant of specific causes of actions, potential abuses of the system have been handled because the courts have dismissed dilatory actions. However, the courts may be less willing to dismiss these actions if brought under a specific cause of action granted by Congress. This is a back door attempt to thwart takeover activity by using, or rather misusing, an already over-burdened judicial system to thwart takeover activity. The real purpose of S. 1323 should become readily apparent by now.

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[164] On April 28, 1987, the Supreme Court issued an opinion in *Tull* v. *United States*, 55 L.W. 4571 (April 28, 1987) which will have a major impact on the SEC's enforcement program against insider trading. The Court held the Seventh Amendment of the Constitution guarantees that a defendant is entitled to a jury in determining *liability* in an action by the Government seeking injunctive relief and civil penalties under the Clean Water Act. The Court held, however, that the *amount* of the civil penalty, if any, to be imposed should be determined by the trial court and not the jury.

According to the Supreme Court, a civil penalty—a remedy principally to exact punishment (analogous to punitive damages)—was issued at common law by courts of law, not courts of equity. The Court cited as reasons for the penalty—restitution, deterrence and retribution. The court indicated that restitution for wrongful conduct should be based on the seriousness of the violations, the number of prior violations and the lack of good-faith efforts to comply with the relevant requirements. The Court also recognized that the penalty might seek to deter future violations by basing the penalty on its economic impact.

The requirement that the SEC litigate liability issues before a jury in any action seeking injunctive relief and a civil penalty, will adversely impact the SEC's insider trading enforcement program. Since 1984, in almost every one of those actions, the SEC has sought a civil penalty under the Insider Trading Sanctions Act in addition to injunctive relief. In order to settle such actions, the SEC has required defendants to consent to a civil penalty of at least one time (and often two times) the amount of profit gained or loss avoided. Requiring jury trials in insider trading cases will tax staff resources, will lead to greater chances of error or mistake by the staff in the presentation of the case and may make the settlement of such cases in certain circumstances where the staff is seeking a substantial remedy, less desirable from the defendant's point of view.

Even in those situations where a defendant wants to settle, the *Tull* decision will impact the settlement negotiations. It will give a defendant leverage in negotiating no civil penalty or a reduced civil penalty as a condition of settlement. The decision will also force the SEC in certain cases to forego seeking the civil penalty. For example, in a case where the SEC wants to move for temporary or preliminary relief, it might well decide not to seek a civil penalty in order to avoid the necessity of the jury trial on liability issues.

See also, Mathews, Levine and Roe, An Assessment of the Insider Trading Sanctions Act After *Tull* v. *United States*, Insights, Vol. 1, no. 2, August 1987, pp. 8, 18–22.

Further, private litigants have a myriad of implied private rights of action under which they can bring suit. For example, the courts have recognized an implied private right of action under the Williams Act (Section 14(e)) for fraudulent communications and activities pursuant to a takeover as well as the general anti-fraud provisions of Section 10(b) and Rule 10b–6. Further, the courts have recognized implied rights of action for violations of Sections 13(d), 13(e) and 14(d) of the Exchange Act. These rights of action apply to failures and delays to file as well as misstatements. Violations of these sections can give rise to potential criminal penalties as well as SEC enforcement actions.

Finally, existing Section 18(a) of the Exchange Act provides an explicit private remedy for misstatements in filings made pursuant to Sections 13(d) and 14(d) of The Exchange Act. The private litigant must demonstrate a reliance on these filings to recover.

Finally, the imposition the new civil penalties provided in Section 6 should impose only upon a showing of scienter or recklessness. In light of the severity of the penalties imposed under Section 6, the application of a negligence standard may prove unfair. Thus, consideration should be given to an amendment that would satisfy this concern.

E. SECTION 7—MINIMUM OFFERING PERIOD

In light of the other obstacles S. 1323 creates to tender offers, the 35 business day minimum offering period is too long. The amendment presently contemplated would increase the minimum offering period to 25 business days. Due to the telecommunications revolution and the publicity surrounding these offers, 25 business days which is approximately 33 to 35 calendar days appears to be sufficient for anyone to analyze the market situation. It also provides management adequate time to engage in defensive tactics designed to thwart any unwanted offer.

In its submission to the Committee, the American Bar Association opposed extension of the minimum offering period.

> We question whether any marginal benefits to investors of a 35 business day period will be outweighed by the adverse effects on the tender offer process caused by such a period. The longer an offer remains open, the greater the risks involved. The greater the risk of failure of the bid, the less likely it will be made in the first place. If a bidder is financing its offer in whole or in part from outside sources, such as a bank, a 35 business day minimum period will make such financing more difficult and expensive. This may result not only in fewer tender offers, but lower offering prices for the bids that are made to account for increased financing and other expenses. We also recognize that an extended offering period will give target boards of directors more time to consider a range of alternatives to the bid (which could enhance ultimate value to shareholders). However, it is unclear to us whether courts applying the business judgment rule in takeovers would reach different results on defensive tactics if the tender offer which

led to the company's response were open for a longer period.[165]

The SEC opposed extension of the minimum offering period for similar reasons.[166]

For purposes of insuring adequate disclosure to securityholders, the current minimum tender offer period of 20 business days, required under SEC rules, is more than adequate. Also, 20 business days has generally proven to be enough time for targets to implement appropriate defensive measures or find another bidder. An extension of the minimum period to 35 business days is, therefore, unnecessary. The proposed extension of the period appears to be motivated by a desire to make takeovers more difficult. Obviously, longer holding periods tend to work in favor of the target and to discourage bidders.

Although we strongly support the concept of employee ownership, the additional delay of 60 business days (for a total of 95 business days, or almost five months) where purchases by an employee stock option plan (ESOP) are expected is grossly excessive. This provision creates incentives for companies to set up an ESOP to purchase their shares, or claim to be doing so, for the sole purpose of stringing out a tender offer almost indefinitely.

F. SECTION 8—GREENMAIL

Section 8 is entitled "Actions by Issuers." A more appropriate title would be "Actions Issuers may take against recipients of Greenmail Payments." The so-called anti-greenmail provisions of Section 8 turn American jurisprudence on its head. The Committee entertained much testimony critical of greenmail payments and determined it to be an abusive practice in need of remedy. Greenmail is essentially a business transaction executed by and between two parties—the payer or, the issuer, who pays for receives stock from a shareholder, the greenmail recipient. The Committee has determined that greenmail is an abusive transaction that must be stopped. However, unlike all two-party transactions that are restricted or prohibited, Section 8 imposes liability on the recipient of the payment. Further, Section 8 permits the issuer, or the payer of the greenmail, to sue the recipient of the greenmail. If the transaction is to be invalidated, the recipient of the greenmail should receive some of the sold shares back since full value has not been received for those shares. If greenmail is a practice that is to be discouraged, both parties should be held liable—the payer of the greenmail and the recipient.

Further, as currently drafted, Section 8 would require that the 100% recovery of profit will apply even to a gain that would accrue in a sale at the market price. Thus, this provision is not limited to profit from selling stock back to the issuer at more than the market price. Also, the one year holding period may be too long and, in requiring shareholder approval, it may be prudent to "sterilize" management's shares by requiring a majority approval of disinterested stockholders.

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[165] S. Hrg. 100-183, Regulating Hostile Corporate Takeovers at 503-504.
[166] *Id.* at 95-96.

Therefore, S. 1323 should be amended to include the greenmail provisions contained in S. 1323 as originally introduced. [See Part II, Section F. of the Views for a discussion of such an amendment.]

G. SECTION 9—REGISTRATION OF ARBITRAGEURS

A vast majority of arbitrageurs are employed by investment banking firms and therefore are already required to register with the Commission under the broker-dealer registration provisions of The Exchange Act. The definition is so broad that virtually any funds manager using an asset based valuation strategy would have to register with the SEC as an arbitrageur. Many banks have arbitrage departments and SEC registration may be required since no exemptions for such activities are provided by Section 9. Further, whether registered or not, arbitrageurs are subject to the antifraud provisions of the federal securities laws.

The SEC opposes this section because it creates definitional problems and would have been unnecessary to further SEC prosecutions. The SEC's concerns are similar to those of the ABA which are provided below.

The ABA's submission to the Committee articulates concerns with regard to the registration of tender offer arbitrageurs:

> We question the need for registering and regulating "tender offer arbitrageurs." Arbitrageurs are already subject to existing laws and rules which regulate their activities including the general antifraud rules and Rule 14e-3 which limit their ability to buy or sell securities while in possession of material inside information, the Section 13(d) reporting requirements and insider trading sanctions. We fail to see the need for special regulation of tender offer arbitrage.
>
> Moreover, we would be wary of any step which would lead to a limitation or discontinuance of risk arbitrage. The SEC has recognized the vital role played by arbitrageurs in the maintenance of the efficiency and liquidity of the American capital market. According to the SEC:
>
> > "Arbitrageurs in a tender offer typically make money on the differential between the market price at the time the tender offer is announced and the tender price, which normally includes a premium above market. Their purchases enable the public investor to elect to avoid the risk that the tender will not be consummated or that it will be prorated." Exchange Act Release No. 34-9325.
>
> There are serious definitional problems with the term "tender offer arbitrageur" as included in the proposed bill. According to the bill, the term refers to any person "who regularly buys and sells, for its own account, or for the account of others, in response to, or in anticipation of, a merger, tender offer, recapitalization, restructuring or similar transaction." Many different kinds of investors do precisely this. While the bill would exempt certain types of investors such as natural persons, mutual funds and employee benefit plans, all other investors would either have to register, or avoid regularly buying and selling stocks of companies which might be the subject of a tender offer or recapitalization or "similar transaction", on

pain of violating a registration requirement. Would the University of Michigan have to register as an arbitrageur? The Roman Catholic Church? The definitional problems are obvious and serious.[167]

Thus, registration of arbitrageurs is unnecessary, and Section 9 exacerbates the problem by being overbroad.

H. SECTION 12—CHINESE WALLS

The Chinese Wall provisions of S. 1323 also contain certain deficiencies.

The proposal to give the SEC authority to mandate internal procedures such as Chinese Walls, is also fraught with peril. Generally, the problems uncovered by the SEC recently have not involved the lack of procedures at broker-dealers. In fact, most broker-dealers have comprehensive policies and procedures and it is neither necessary nor prudent to involve the SEC or the SROs in forcing the adoption and maintenance of those procedures to a degree greater than required by current law. The proposed legislation would unnecessarily thrust the SEC into the internal operations of broker-dealers.[168]

Because of the manner in which the Chinese Wall section is drafted, it could lead to massive civil liability every time that a broker-dealer's procedures are found to have fallen short of the SEC's rules. This results from the interplay of the provision with Section 29(b) of the 1934 Act.

The Chinese Wall section would, as noted above, make it unlawful for a broker-dealer to engage in securities transactions without having in place Chinese Wall procedures which meet the SEC standards. Section 29(b) of the 1934 Act currently gives a broker's customers the right to rescind any contract which is made in violation of any section of the Act or any SEC rule adopted thereunder. The net effect of the Chinese Wall provision, as currently drafted, would therefore be to subject broker-dealers to the potential of massive liability for even minor deficiencies in their information policies and procedures.

For example, if a broker-dealer's procedures were judged to be inadequate, all customers who effected trades with the broker-dealer during the time those procedures were in place would appear to have a right under Section 29(b) of the Act to rescind their trades. This would be so irrespective of whether the trades were in any way related to the defect in the procedures. Section 29(b) does not require that the customers demonstrate that they suffered any losses as a result of the violation. Section 29(b) operates automatically without regard to the cause of the investors' losses.

Thus, customers who suffered losses as a result of general market movements would be given the right to transfer the losses to the broker any time the broker is determined to have violated SEC rules adopted pursuant to the Chinese Wall section of S. 1323. When the deficient procedures have been in place for several years, the total damages could be enormous.

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[167] *Id.* at 517-518.

[168] *See* Memorandum from T. Levine of Wilmer, Cutler and Pickering to clients (October 9, 1987).

The sum, insufficient attention has been given to the potential civil consequences of imposing Chinese Wall procedures in the manner contemplated by S. 1323.

The provision is unnecessary because broker-dealers are already subject to incentives to ensure that they have adequate procedures in the area of control and use of inside information. If broker-dealers do not have such procedures in place, they are subject to discipline under Section 15(b)(4) by the SEC for failure to reasonably supervise employees. Section 15(b)(4)(E) provides the SEC with the authority to sanction any broker-dealer which "has failed reasonably to supervise, with a view to preventing violations of the provisions of [the federal securities laws], another person who commits a violation, if such person is subject to his supervision". Self Regulatory organizations ("SROs") have similar authority. Broker-dealers also can be held liable in damages in private actions under Section 20(a) of the 1934 Act if they do not attempt to supervise employees with a view to preventing violations. Finally, reasonable information policies are essential to a defense in Rule 14e-3 prosecutions for illegal use of tender offer information.

The provision will also interfere with industry efforts to advise appropriate standards. The adoption of the Chinese Wall section will undermine efforts by the stock exchanges of the NASD to find reasonable ways to improve existing procedures relating to the control and use of nonpublic information. The self-examination which is currently under way offers the best chance to find the right answers. Moreover, the SROs must obtain SEC approval for any new rules which they adopt in this area. Thus, the SEC will play the role intended by S. 1323.

I. SECTION 14–CRIMINAL PENALTIES FOR INSIDE TRADING

The penalties imposed for violations of the provisions of S.1323 and existing provisions of the Williams Act could actually impede, rather than facilitate the SEC's enforcement efforts. This unintended consequence of S. 1323 could result in complicating the SEC's enforcement efforts.

The progress of the proposed legislation should be followed closely. The increased enforcement remedies being proposed can have a draconian effect on tender offers. The existing remedies are more than adequate. The statutory remedies of divestiture or civil penalties for tender offer type violations will hinder rather than help the SEC's efforts to protect investors and maintain neutrality in control contests. The increased criminal penalties for insider trading violations far beyond that what is necessary to address the insider trading abused being uncovered by the SEC.

What is of greatest concern about the proposed legislation is the "criminalization" of the enforcement process. Historically, the SEC has been able to obtain compliance with the securities laws and maintain the integrity of the securities markets through an enforcement program which has emphasized the remedial nature of the program. The proposed legislation is part of a growing trend to shift the SEC's efforts from "remedial" to "drastic" approaches. Ultimately, this shift will hinder

the SEC's efforts and be a disincentive to self-regulation—a hallmark of the securities industry over the last two decades.[169]

While increased penalties to deter insider trading, such penalties should be more carefully considered before they are enacted. At present, no definition of insider trading exists. Before increased civil and criminal penalties are mandated for inside trading, the crime should be defined. At present, the Securities Subcommittee of the Committee has extensively studied these issues and a statutory definition of insider trading is forthcoming.[170] The increased penalty provisions should be included in legislation defining the crime.

Conclusion

In its current form, S. 1323 fails to satisfy either of the major purposes of the Williams Act. First, the combination of the anti-takeover provisions of S. 1323, the myriad of defensive tactics employed by target managements and recently enacted state anti-takeover legislation upset the balance between bidders and targets that the Williams Act sought to establish. Second, the provisions of S. 1323 examined in Part III of these views do little to enhance the investor protections provided by the Williams Act.

The Committee's approval of S. 1323 represents at least an implicit judgment that corporate takeover activity has adverse economic consequences and therefore must be restricted. Neither the testimony received by the Committee nor the Report supports such a judgment. From the available evidence, it appears that the market for corporate control has worked and is working well. Insufficient evidence has been presented to the Committee to support the conclusion that takeover activity should be impeded through the enactment of those provisions discussed in Part III. Both economic theory and the great weight of the available empirical evidence clearly demonstrate that takeovers have provided net benefits to the American economy. Admittedly, some forms of takeover activity, hostile, friendly or management buyouts, result in temporary social and economic dislocations. However, these dislocations are no less severe than unilateral actions taken by corporate managements that are totally divorced from takeover activity. Actions such as plant closings and relocations, headquarter relocations and job loss due to general economic conditions cause far more social and economic dislocation than corporate takeover activity. While some of the recent takeover activity may ultimately be subject to the same criticism that has been levelled at the conglomerate merger wave of the 1960's and 1970's, from past experience, it is clear that the federal government is less capable of distinguishing between beneficial and detrimental takeover activity than are the

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[169] *Id.*

[170] *See* S.Hrg. 100-155, Definition of Insider Trading, Hearings before the Securities Subcommittee, Senate Banking Committee, 100th Cong. 1st Sess. (June 17, 19, August 7 and December 15, 1987) Parts I, II and III for a discussion of S. 1380, the Insider Trading Proscriptions Act. S. 1380 was introduced by Senators D'Amato and Riegle on June 17, 1987. To date, four hearings have been held in the 100th Congress regarding the need for a statutory definition of insider trading.

private parties who have better financial information and a substantial financial incentive to be right in making the judgments.

ALFONSE D'AMATO.

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